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U.S.-Japan Currency Agreement Includes Cut In Japan's Discount Rate

In an October 31 agreement between the United States and Japan, Washington agreed to end its pressure for a stronger yen in exchange for more stimulative economic policies by Tokyo. The accord stated that "the exchange rate realignment achieved between the yen and the dollar since the Plaza agreement is now broadly consistent with the present underlying fundamentals." Recognizing the threat of currency instability to economic growth, the two sides agreed "to cooperate on exchange market issues." Some observers interpreted this as the establishment of a de facto target zone that will be maintained by joint intervention. Although it stated that measures by other industrial nations are critical to promote world growth, the agreement did not include the European countries.

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Government Submits Supplementary Budget To Diet

Tokyo's long-awaited FY 1986 supplementary budget was sent to the Diet October 31 to implement the economic stimulus package announced September 19. The budget calls for a Y549 billion ($3.5 billion at Y155=$1.00) issue of construction bonds to fund public works (see Table). Finance Minister Kiichi Miyazawa said the government has done its best to stimulate the economy, given the fiscal constraints it faces.

FY 1986 Supplementary Budget*

(in billions of yen)

Expenditures	Amount
Public Works	Y549.0
General Public Works	133.0
Disaster Relief Projects	416.0
Incentives for Private-Sector Investment	3.3
Small and Medium Business Programs	25.2
Civil Service Wage Increases	133.8
Fishing Industry Adjustment	19.6
Transfer from National Bond Redemption Fund	-410.0
Transfer to Special Oil Account	-54.0
Transfers to Local Governments	-450.2
Unused Funds	-452.0
National Bond Interest Payment Fund	-253.8
Fuel Fund	-74.0
Reserve Fund	-150.0
Other	521.5
Total	-263.8

Revenue	Amount
Taxes	Y-1,120.0
Income	-426.0
Corporate	-981.0
Oil	-205.0
Tariffs	-75.0
Inheritance	219.0
Securities Transfer	348.0
Non-Tax Revenue	-133.4
Bank of Japan Contribution	-197.9
Construction Bonds	549.0
Budget Surplus from FY 1985	440.5
Total	-263.8

*Change from the initial general account budget passed in April 1986.

Source: Nihon Keizai Shimbun, October 28, 1986

The Y3.6 trillion ($23.2 billion) stimulative package adopted by the cabinet in mid-September is designed to help the economy achieve the government's outlook of 4 percent real growth in FY 1986. Its key component is Y1.4 trillion ($9 billion) in additional public works spending. Of this total, Y602 billion ($3.9 billion) will be financed in future budgets and Y243 billion ($1.6 billion) will be handled by local governments, leaving Y549 billion to be funded by this year's supplementary budget. The stimulus package also includes Y800 billion ($5.2 billion) in regional projects to be financed by local governments; higher loan ceilings for the Housing Loan Corp. to induce an additional Y700 billion ($4.5 billion) in housing construction; and Y100 billion ($645 million) in road construction to be financed under the Fiscal Investment and Loan Program. The government is also projecting Y360 billion ($2.3 billion) in additional private-sector investment by electric and gas utilities and Kokusai Denshin Denwa Co., Ltd., Japan's international common carrier.

Because of the slowing economy, the Ministry of Finance anticipates revenue in FY 1986 to fall Y1,253 billion ($8.1 billion) short of its original projections (see JEI Report No. 1B, January 10, 1986). Tax revenue, projected to rise 6.2 percent, was up only 0.2 percent in August from a year earlier. Smaller-then-expected summer bonuses and cutbacks in overtime work have slowed the increase in individual earnings, and revenue from corporate taxes has dipped substantially, reflecting the effect of the strong yen on business activities. Oil tax revenue is down due to the drop in oil prices, while cheaper import prices and lower tariff rates have cut customs revenue.

In line with its goal of ending reliance on deficit-covering bonds by FY 1990, the government plans to cover this fiscal year's expected revenue shortfall with Y441 billion ($2.8 billion) in reserves carried over from FY 1985 and with savings in other expenditures. Lower oil prices will limit expenses in many areas, particularly defense. Moreover, falling interest rates have reduced the cost of financing the national debt. As a result of these savings, FY 1986 government expenditures will be Y263.8 billion ($1.7 billion) below the original budget, despite increased outlays on public works (see JEI Report No. 11B, March 21, 1986).

Randall S. Jones

Japanese Firms Enlarge Wall Street Presence

The trend toward integration of national financial markets was highlighted recently when the Industrial Bank of Japan, Ltd. announced that one of its subsidiaries was poised to purchase an elite U.S. securities broker. The move, along with an agreement between Sumitomo Bank, Ltd. and Goldman, Sachs & Co., underscores the drive by Japanese firms to establish a strong presence in American financial markets. This has generated some grumbling by American competitors that claim that reciprocal opportunities are not available for U.S. firms in Japan. While federal authorities do have the power to block both agreements, approval is likely.

Sumitomo Bank first stirred the waters on August 6 by confirming rumors that it was negotiating a limited partnership arrangement with Goldman, Sachs, one of Wall Street's largest privately held investment bankers. The third-largest Japanese commercial bank (with assets of Y32.2 trillion -- $207.7

STATISTICAL SUPPLEMENT

Trade and Payments Data
(in millions of dollars unless otherwise indicated)

	1984	1985	January-September 1985	January-September 1986	July 1986	August 1986	September 1986
Japan's Balance of Payments							
Trade Balance	$44,257	$55,986	$38,207	$65,053*	$8,666*	$8,114*	$9,799*
Exports (f.o.b.)	168,290	174,015	124,872	150,963*	18,514*	16,627*	18,739*
Imports (f.o.b.)	124,033	118,029	86,665	85,910*	9,848*	8,513*	8,940*
Current Account Balance	35,003	49,169	33,175	59,953*	8,026*	7,054*	9,106*
Long-Term Capital (net)	-49,651	-64,542	-45,830	-86,427*	-11,958*	-13,162*	13,435*
Overall Balance	-15,200	-12,318	-9,085	-20,295	-629	-5,472	-3,872
International Reserves (end of period)	26,313	26,510	27,523	41,456	38,330	41,214	41,456
Japan's Customs Clearance Trade							
Trade Balance	33,611	46,099	30,315	58,746*	8,194	7,478	8,920*
Exports (f.o.b.)	170,114	175,638	126,160	153,433*	18,895	16,837	19,002*
Cars	21,899	25,402	17,845	24,437*	3,066	2,550	2,910*
Steel	13,852	13,566	10,023	9,450*	1,171	1,070	1,056*
Imports (c.i.f.)	136,503	129,539	95,846	94,687*	10,701	9,359	10,082*
Crude Oil	39,379	34,599	25,376	15,569*	1,075	1,076	1,030*
Japan-U.S. Trade							
Trade Balance	33,075	39,485	27,274	36,818*	4,515	4,416	4,805*
Exports (f.o.b.)	59,937	65,378	46,797	58,875*	7,490	6,498	7,258*
Imports (c.i.f.)	26,862	25,793	19,523	22,057*	2,975	2,082	2,453*
U.S.-Japan Trade							
Trade Balance (f.a.s./c.i.f.)	-36,796	-49,749	-36,938	-43,028	-5,505	-4,701	-4,120
Trade Balance (f.a.s./Customs)	-33,560	-46,152	-34,219	-40,340	-5,161	-4,422	-3,869
Exports (f.a.s.)	23,575	22,631	17,064	20,301	2,941	2,272	2,015
Industrial Supplies	9,139	8,680	6,468	6,281	624	725	810
Food and Feed	5,929	5,001	3,773	3,754	462	553	395
Capital Goods	5,627	5,939	4,490	4,815	650	588	555
Consumer Goods	1,476	1,416	1,093	1,239	143	168	138
Imports (Customs)	57,135	68,783	51,282	60,641	8,102	6,694	5,884
Automotive Products	18,477	24,980	18,197	24,116	3,525	2,734	2,129
Capital Goods	19,290	21,516	16,314	18,740	2,347	2,093	1,968
Consumer Goods	11,266	14,017	10,364	11,458	1,428	1,213	1,173
Industrial Supplies	7,276	7,035	5,504	5,339	676	543	509
Imports (c.i.f.)	60,371	72,380	54,002	63,328	8,446	6,973	6,136

*Preliminary

STATISTICAL SUPPLEMENT

Japanese Economic Indicators

(percentage change from year-earlier period unless otherwise indicated)

	1984	1985	January-August 1985	January-August 1986	June 1986	July 1986	August 1986
Discount Rate (end of period)	5.0%	5.0%	5.0%	3.5%	3.5%	3.5%	3.5%
Outstanding Money Supply	7.8%	8.4%	8.1%	8.7%	8.5%	8.7%	8.9%
Industrial Production	11.1%	4.6%	6.2%	-0.3%	0.2%	-1.5%	-3.0%
Manufacturing Operating Rate	7.3%	1.2%	1.9%	-4.1%	-4.4%	-5.6%	-7.8%
Number of Bankruptcies	8.8%	-9.7%	-8.9%	-7.7%	-3.6%	-8.2%	-8.0%
Residential Construction Starts	4.4%	4.1%	3.6%	7.1%	4.7%	13.5%	19.4%
Job Openings to Applications (ratio)	0.65	0.68	0.69	0.63	0.60	0.61	0.61
Nominal Wages	4.3%	3.6%	3.9%	3.8%	4.8%	3.9%	1.6%
Labor Productivity	9.9%	4.2%	6.1%*	2.2%*	2.0%	n.a.	n.a.
Wholesale Prices	-0.3%	-1.1%	0.0%	-8.7%	-10.1%	-10.7%	-11.2%
Consumer Prices	2.3%	2.0%	2.3%	0.9%	0.6%	0.1%	0.1%
Yen-Based Export Prices	0.6%	-1.4%	2.0%	-15.9%	-16.5%	-17.5%	-17.8%
Yen-Based Import Prices	-3.4%	-2.5%	1.1%	-33.1%	-39.6%	-41.9%	-43.9%

*Through June of each year only.

For Japan's most recent GNP figures, see JEI Report No. 34B, September 19, 1986.

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JAPAN · ECONOMIC · INSTITUTE

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REPORT

NO. 42A November 14, 1986

JAPAN'S ROLE IN WORLD FINANCIAL MARKETS

Summary

The integration of world financial markets has progressed rapidly during the past decade as deregulation and technological progress have reduced the significance of national boundaries. The recycling of large trade surpluses and the financing needs of multinational corporations have also encouraged this trend. It is not surprising that Japan with its high saving rate and huge current account surpluses plays an important role in world financial markets. Japanese financial institutions' share of the international banking and securities markets has risen steadily in recent years, and as a result of the strong yen, more Japanese companies are seeking to lower costs through overseas production.

Japan's emergence as the world's leading exporter of capital gives it tremendous influence and power. Tokyo is fast becoming a major financial center along with New York and London, and international use of the yen in trade and investment as well as a reserve currency is increasing. The overseas expansion of Japanese financial institutions will accelerate financial liberalization at home. And Japan, now the world's largest creditor nation, will be called on to play a more central role in managing the debt problems of developing countries. Inevitably, though, the success of Japanese banks and securities firms abroad is creating a new area of international friction.

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Japan's Rising Importance in World Finance

Like Britain and the United States before it, Japan's success in manufacturing has allowed it to become a financial power as well. As the free world's second-largest economic power, Japan accounted for about 10 percent of both global output and exports in 1985. Its trade surplus in 1986, predicted to reach $85 billion, will be equivalent to about 4.1 percent of the country's gross national product, a figure that exceeds the 3.8 percent recorded by Britain at the height of its empire and the 4 percent attained by the United States after World War II.

Its big external surpluses reflect the domestic saving-investment imbalance in Japan, where the private saving rate is considerably higher than in most other countries. During the 1970s these savings were largely absorbed by industry and the government (see Table 1). Business investment, however, has fallen since the first oil shock in 1973, and a fiscal austerity program aimed at lowering government deficits has been in effect since 1981. The result is a growing surplus of savings to be invested overseas. Japan's net long-term capital outflow totaled $64.5 billion in 1985, making it the largest net creditor nation with net foreign assets of $129.8 billion as of December 31 (see Table 2). Holdings of overseas securities account for much of the private sector's long-term assets (see Table 3).

Table 1: Japan's Saving and Investment

(percent of gross national product)

Years	Gross Domestic Investment	Gross Domestic Saving	Public Sector Deficit
1971-79 Average	33.5%	34.2%	-6.3%
1980	32.2	31.1	-6.7
1981	31.3	31.7	-7.3
1982	30.1	30.8	-6.9
1983	28.3	30.1	-6.8
1984	28.2	31.0	-5.8
1985	28.2	32.1	-3.6

Source: Bank for International Settlements, Fifty-Sixth Annual Report.

It should be noted that Japan only emerged as a major capital supplier in the past four years. From 1970 to 1980, its current account averaged a small surplus of $1.9 billion. At the end of 1981, Japan's net external assets totaled only $10.9 billion compared to $140.7 billion for the United States, then the largest net creditor nation. But Japan's large trade surpluses enabled it to overtake Britain, Saudi Arabia and the United States, which became a debtor nation in 1985 for the first time since World War I with net liabilities of $107.4 billion.

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Table 2: Japan's Net External Assets

(in millions of dollars)

End of Year	Private Sector	Government Sector	Total
1971	$-7,088	$16,861	$9,773
1972	-6,820	20,687	13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821

Source: Bank of Japan, Balance of Payments Monthly, April 1986.

Table 3: Japan's External Assets and Liabilities

(in millions of dollars)

	Assets		Liabilities	
	End of 1984	End of 1985	End of 1984	End of 1985
Long-Term	$229,184	$301,297	$113,222	$122,328
Private Sector	191,946	264,458	83,738	91,776
Direct Investments	37,921	43,974	4,458	4,743
Trade Credits	22,824	23,603	24	131
Loans	40,601	46,870	1,266	1,211
Securities	87,578	145,748	77,081	84,847
Others	3,022	4,263	909	844
Government Sector	37,238	36,839	29,484	30,552
Trade Credits	1,189	1,062	103	84
Loans	24,491	23,293	29,381	30,468
Others	11,558	12,484	0	0
Short-Term	112,024	136,404	153,640	185,552
Private Sector	84,761	108,753	145,900	176,985
Monetary Movements	77,562	99,719	130,098	160,984
Others	7,199	9,034	15,802	16,001
Government Sector	27,263	27,651	7,740	8,567
Monetary Movements	27,261	27,650	3,590	4,557
Others	2	1	4,150	4,010
Total	341,208	437,701	266,862	307,880

Source: Bank of Japan, Balance of Payments Monthly, April 1986.

Domestic financial market deregulation has allowed Japan to develop into a major financial power. Prior to the first oil crisis, its capital markets operated in isolation and under tight regulations. A high degree of specialization among financial institutions and interest rate controls limited access to the markets and concentrated power in the Ministry of Finance and the central bank. Controls on international capital flows and foreign exchange transactions insulated Japan's financial structure from foreign influences. Although the regulations introduced inefficiencies into financial markets, the system was well suited to Japan's need for low-cost capital to increase productive capacity in the years after the war.

Economic events in the 1970s led to forces for change in the rigid financial structure. The two major oil price increases and the breakdown of the fixed exchange rate system resulted in higher rates of inflation, slower economic growth and volatile movements in the value of the yen. The increase in outstanding government debt, which rose from 6 percent of GNP in FY 1972 to 28.8 percent in FY 1980, also had a major impact. It resulted in the rapid development of Japan's primary and secondary bond markets and gave rise to pressures from the financial community for improvements in the efficiency of these markets.

Tokyo's development as a global financial center began in earnest with the Foreign Exchange Control Law of 1980, which made free international financial transactions the rule rather than the exception. The pace of financial liberalization was accelerated by the yen/dollar accord between Japan and the United States in May 1984. Under this agreement, intended to promote the internationalization of the yen, Tokyo took steps to deregulate the Euroyen market and gradually liberalize interest rates on large bank deposits. It also agreed to create a yen-denominated banker's acceptance market and to allow foreign banks to enter the trust banking business in Japan (see JEI Report No. 22B, June 8, 1984).

The Role Of Japanese Banks

Foreign medium- and long-term loans of $58 billion in 1985 enabled Japanese banks to overtake U.S. banks as the world's biggest lenders. They now account for one-fourth of international banking assets, well above this country's 18 percent share. The emergence of Japanese banks has occurred rather suddenly, considering that many only began overseas lending in 1980 when Tokyo eased controls on capital flows. With the realignment of exchange rates during the past 18 months, the competitive lineup has changed dramatically; seven of the ten largest banks in the world are now Japanese (see Table 4). They have also made important inroads in U.S. retail banking; for example, five of the top 11 banks in California are Japanese-owned.

This prominence is partially a result of a profit squeeze at home that sent Japanese banks scrambling overseas for new markets. Interest rate controls have been lifted on time deposits of Y300 million or more ($1.9 million at Y160=$1.00), and further deregulation is expected in the spring of 1987. As a result, roughly two-thirds of the new funds in commercial banks now come from instruments with market-determined interest rates compared with less than one-third five years ago. Banking sources say that liberalization may have already cost banks as much as one-tenth of their net income in the form of higher interest payments to depositors.

Table 4: World's Top Ten Commercial and Investment Banks, 1985

(in billions of dollars)

Commercial Banks	Assets*	Investment Banks	Equity*
Dai-Ichi Kangyo (Japan)	$190.0	Nomura Securities (Japan)	$3.4
Citicorp (U.S.A.)	173.6	Merrill Lynch (U.S.A.)	2.3
Fuji (Japan)	170.3	Nikko Securities (Japan)	2.1
Sumitomo (Japan)	164.9	Daiwa Securities (Japan)	2.0
Mitsubishi (Japan)	161.5	Salomon Brothers (U.S.A.)	1.7
Sanwa (Japan)	150.0	Yamaichi Securities (Japan)	1.6
Norinchukin (Japan)	136.9	Shearson Lehman Bros. (U.S.A.)	1.2
Industrial Bank of Japan	125.7	Prudential-Bache Securities (U.S.A.)	1.0
Banque Nationale de Paris (France)	123.1	Dean Witter Financial Services (U.S.A.)	0.9
Credit Agricole (France)	122.9	Goldman, Sachs (U.S.A.)	0.9

*Assets/equity as of March 31, 1986 for Japanese banks and December 31, 1985 for all others. The sharp appreciation of the yen has led to a significant reordering of the ranking.

Source: Fortune, October 27, 1986.

Weak demand for loans by the corporate sector, which has enjoyed three years of record profits, has also encouraged Japanese banks to expand overseas. And even when they do need to borrow, companies find that they can raise funds more easily in the Eurobond market. Overseas financing now accounts for almost half of the money raised by corporate Japan. Large firms have reduced their reliance on bank loans sharply -- from 80 percent in the first half of the 1970s to 43 percent in 1984 -- and this trend will continue as regulations governing corporate bond issues are eased. Even medium-sized firms, which currently rely almost entirely on bank loans, are likely to diversify their fund-raising activities.

Yet another strong motivation for overseas expansion is the opportunity to engage in the securities business -- an activity in which banks are limited in Japan. Most European countries generally permit universal banking. Although U.S. law continues to separate commercial and investment banking, the distinction is becoming increasingly blurred. The "securitization" of financial transactions has made it increasingly important for commercial banks to gain expertise in the area of securities. According to the Bank for International Settlements, net international bank lending fell from $165 billion in 1981 to $100 billion in 1985, while net bond financing rose from $32 billion to $125 billion. The importance of the securities business was further emphasized two years ago when Nomura Securities Co., Ltd. edged out Sumitomo Bank, Ltd. as the most profitable Japanese financial institution. The need to learn more about the securities market led to Sumitomo's recent proposal to invest $500 million in investment banker Goldman, Sachs & Co. (see JEI Report No. 41B, November 7, 1986).

Japanese banks, though, have several weaknesses that will slow their expanding world role. First, their profits are weak by international standards. Dai-Ichi Kangyo Bank, Ltd., for example, the largest in the world, ranked only sixteenth in net earnings. According to the Federation of Bankers Association of Japan, the assets-to-earnings ratio in Japan in 1984 was only 0.54 percent, well behind this country's 0.81 percent rate and West Germany's 1.06 percent. Second, Japanese banks are thinly capitalized, with a capital-to-assets ratio of only 3.4 percent in 1984 compared to 6 percent for U.S. banks and 6.6 percent for West German banks. In a precautionary move taken September 1, the Ministry of Finance now requires a bank to raise its capital before expanding foreign lending beyond a certain level.

Tokyo's offshore banking facility, scheduled to open December 1, will likely fall short of international and domestic expectations, reducing the expected benefits to Japanese banks. Bankers have criticized the government's plan to tax funds moving through the facility, arguing that it will limit volume. Yusuke Kashiwagi, chairman of the Bank of Tokyo, Ltd., predicts that annual turnover will be only $20 billion if taxes are imposed. The MOF anticipates that initial turnover could be as large as $70 to $80 billion and that it will equal Singapore's $180 billion volume within a short time.

Although most of what are now the international banking community's problem loans to third world countries had already been made by the time Japanese banks became major lenders, they, too, have been affected by the debt problems of developing countries. Banks in Japan hold 10 to 15 percent of all third world debt, with two-thirds of that exposure in Latin America. In addition, they have the biggest slice of the Philippines' debt on their books, as well as a quarter of Indonesia's and 15 percent of Mexico's. Thus far, Japanese banks have been forced to reschedule at least four-fifths of their loans to developing countries. Hard hit by falling oil prices and the appreciation of the yen, Indonesia is also likely to seek rescheduling of the yen component of its debt.

Not surprisingly, the success of Japanese banks has led to trade frictions, particularly in Britain, where they hold 23 percent of all banking assets. Competitors complain that Japanese banks are all too willing to sacrifice profits for market share by underpricing financial services. Banks in Europe and the United States also charge that Japan's lower capital-to-assets requirement gives their Japanese rivals an unfair cost advantage. This criticism has been echoed by some members of the Federal Reserve Board when examining applications by Japanese banks to take over California banks or set up new U.S. banking institutions -- for example, Mitsubishi Bank, Ltd.'s 1984 acquisition of BanCal Tri-State Corp., the holding company for the Bank of California (see JEI Report No. 42A, November 2, 1984) or the establishment of a New York City bank earlier this year by Mitsubishi Trust & Banking Corp.

Japan's Role in the World Securities Market

The internationalization of Japan's securities markets was set in motion in 1980 by the flow of petrodollars into Japanese stocks and bonds. It has continued over the past four years with the recycling of Japan's enormous trade surpluses. In 1981, Japanese purchases and sales of foreign bonds totaled only $13 billion, with net purchases of $5.8 billion. During the first six months of 1986, however, two-way trading was nearly $1.2 trillion, and net purchases had jumped to $42.1 billion, accounting for 72.9 percent of Japan's long-term capital outlow during that period. Moreover, Japanese corporations have become important borrowers in international bond markets, with an eight-fold rise in the value of corporate bonds issued on overseas markets during the past 10 years.

These large capital flows have propelled Japanese investment banks to the front ranks, where they currently hold four of the top six positions despite a fairly static domestic market (see Table 4). In contrast to their overseas borrowing, the value of corporate bonds issued in the domestic market has been virtually flat in the past decade, discouraged by government regulations covering the issuing terms and fees.

Euroyen bonds (yen bonds issued outside Japan) have been the fastest growing segment of the Eurobond market and now rival the Deutsche mark as the second-largest sector. In the first half of 1986, $8 billion worth of Euroyen bonds were issued, up from $6.5 billion in all of 1985. Tokyo's decision to lower the minimum credit rating for borrowers and allow foreign banks to issue Euroyen bonds spurred the increased volume of lending, as did the rising yen, which encouraged investors to buy yen-denominated securities. This has helped Japanese securities firms, which handle about 95 percent of new Euroyen bond issues, become major international bond underwriters. Three of the top ten underwriters in the $137 billion-plus Eurobond market are Japanese.

A substantial share of surplus Japanese savings has been invested in U.S. assets, attracted by the size and liquidity of this country's capital markets. Net purchases of U.S. securities by Japanese investors in 1985 totaled $29.9 billion. Japanese investors also play a significant role in the U.S. Treasury securities market, although the financial press often exaggerates their importance. Japanese investors' net purchases of Treasury notes and bonds totaled $19.2 billion last year according to the Treasury Department, with purchases concentrated in longer maturity issues. This represents almost two-thirds of all foreign purchases of Treasury debt last year, and 12.8 percent of net new Treasury financing. Japan's top four securities firms have applied to become primary dealers of Treasury issues, but they could be beaten to the punch by the Industrial Bank of Japan, Ltd. Last month J. Henry Schroder Bank & Trust Co., an IBJ subsidiary, announced plans to buy Aubrey G. Lanston & Co., a primary dealer (see JEI Report No. 41B, November 7, 1986).

Japanese investors have begun to shift some of their capital into foreign equities, although net purchases remain small compared to bond purchases. Trading of overseas stocks rose from $1.6 billion in 1981 to nearly $10 billion last year with net purchases of $1 billion. During the first seven months of 1986, net purchases totaled $3.2 billion, largely in the United States. Some experts predict that Japan could overtake Britain by the end of the year as the largest foreign buyer of U.S. stocks.

There is also increased foreign interest in the Tokyo Stock Exchange, the second-largest in the world (see Table 5). The first six foreign securities firms purchased seats on the Tokyo Stock Exchange in November 1985. As of September 1986, the stock of 30 foreign companies was listed on the Tokyo Stock Exchange (including 13 banks), compared to 11 at the end of 1984. This number is expected to continue rising, reflecting an easing of entry requirements and the eagerness of foreign firms to achieve a presence in Japan and participate in the 24-hour trading movement. With the new listings, there has been a surge in the average daily trading volume of foreign equities from 461,000 in 1985 to 1.2 million during the first eight months of this year.

Table 5: Value of Equities Traded on Principal Exchanges

(converted to U.S. dollars at exchange rates then in effect)

	December 31, 1974		June 30, 1986	
	Billions of dollars	Share	Billions of dollars	Share
United States	$510.4	56.2%	$2,291.1	44.3%
Japan	115.8	12.8	1,428.5	27.6
Britain	37.7	4.2	426.0	8.2
West Germany	45.3	5.0	200.6	3.9
Canada	44.0	4.8	158.0	3.1
France	26.3	2.9	118.8	2.3
Italy	12.2	1.3	100.5	1.9
Switzerland	13.1	1.4	97.8	1.9
Australia	17.6	1.9	64.4	1.2
Netherlands	11.3	1.2	62.3	1.2
Total*	892.4	100.0	5,154.4	100.0

*Includes exchanges not listed above.

Source: Morgan Stanley Capital International Perspective, 1986.

Japanese Foreign Direct Investment

In FY 1985 Japanese investors spent $12.2 billion on foreign direct investment ventures, 20 percent more than in the April 1984-March 1985 period. According to the Japan External Trade Organization, Japan's global direct investment outstanding ranked third at $37.9 billion at the end of 1984 (see Table 6). Despite rapid growth, the total as a share of Japan's GNP is a

Table 6: World Foreign Direct Investment, 1984

(stock values at end of 1984 in billion of U.S. dollars)

	Stock Value	Share of Total	Proportion of GNP	Per Capita*
United States	$233.4	42.5%	6.4%	$995
Britain	85.3	15.5	24.3	1,513
Japan	37.9	6.9	3.1	316
West Germany	36.6	6.7	6.9	598
Canada	31.3	5.7	10.6	1,146
Netherlands	31.2	5.7	28.2	2,143
All others (estimated)	93.3	17.0	---	---
Total (estimated)	549.0	100.0	---	---

Source: Japan External Trade Organization

Table 7: Japan's Foreign Direct Investment by Country, FY 1981-FY 1985

(in millions of dollars)

	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	Cumulative March 31, 1986
United States	$2,354	$2,738	$2,565	$3,360	$5,395	$25,290
Canada	167	167	136	184	100	1,675
North America	2,522	2,905	2,701	3,544	5,495	26,965
Panama	614	722	1,223	1,671	1,533	6,400
Brazil	316	322	410	318	314	4,587
Mexico	82	143	121	56	101	1,330
Peru	4	185	0	6	10	696
Bermuda	32	5	14	29	148	601
Latin America	1,181	1,503	1,878	2,290	2,616	15,636
Indonesia	2,434	410	374	374	408	8,423
Hong Kong	329	400	563	412	131	2,931
Singapore	266	180	322	225	339	2,269
Korea	73	103	129	107	134	1,683
Malaysia	31	83	140	142	79	1,125
Philippines	72	34	65	46	61	892
Taiwan	54	55	103	65	114	761
Thailand	31	94	72	119	48	760
Asia	3,338	1,384	1,847	1,628	1,435	19,463
Kuwait	50	41	66	55	34	1,268
Iran	0	0	1	0	0	1,003
Middle East	96	124	175	273	45	2,972
United Kingdom	110	176	153	318	375	3,141
Netherlands	138	73	113	452	613	1,687
West Germany	116	194	117	245	172	1,343
Luxembourg	104	127	265	315	300	1,216
France	54	102	93	117	67	819
Belgium	107	64	126	71	84	743
Switzerland	67	79	37	229	60	663
Spain	39	19	52	140	91	514
Europe	798	876	990	1,937	1,930	11,002
Liberia	466	434	323	281	159	2,455
Africa	573	489	364	326	172	3,369
Australia	348	370	166	105	468	3,621
Oceania	424	421	191	157	525	4,242
Total	8,931	7,703	8,145	10,155	12,217	83,649

Source: Ministry of Finance

Table 8: Japan's Foreign Direct Investment by Industry, FY 1981-FY 1985

(in millions of dollars)

	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	Cumulative March 31, 1986
Manufacturing Sector	$2,305	$2,076	$2,588	$2,505	$2,352	$24,400
Food Products	142	78	77	118	90	1,091
Textiles	91	67	174	85	28	2,083
Wood Products	65	76	91	115	15	1,120
Chemicals	228	322	450	223	133	3,982
Metals	521	468	479	718	385	5,190
Nonelectric Machinery	207	164	169	185	352	1,971
Electric Machinery	475	267	502	409	513	3,747
Transport Equipment	406	439	486	437	627	3,373
Other	169	195	160	215	208	1,841
Nonmanufacturing Sector	6,516	5,478	5,357	7,429	9,536	56,337
Agriculture/ Forestry	75	40	18	26	12	780
Fisheries	36	22	17	24	42	442
Mining	2,534	685	382	484	598	11,756
Construction	96	44	55	112	94	798
Trade/Sales	1,174	1,899	1,164	1,482	1,550	12,677
Banking/Finance/ Insurance	843	533	1,167	2,085	3,805	10,859
Services	623	702	622	681	665	4,686
Transportation	722	924	1,363	1,651	1,240	5,900
Real Estate	167	354	375	430	1,207	2,533
Other	246	276	193	454	322	5,906
Branch Offices	110	149	200	221	329	2,318
Real Estate Transactions*	---	---	---	---	---	595
Total	8,931	7,703	8,145	10,155	12,217	83,649

*Overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980 because of changes in the Foreign Exchange and Foreign Trade Control Law.

Source: Ministry of Finance

relatively low 3.1 percent. Moreover, Japan's 6.9 percent share of the world total is small compared to the United States and Britain. Both indicators suggest considerable room for expansion.

There has been a marked shift in the pattern of Japan's direct foreign investment from the developing countries to the industrial nations, as shown by a rise in their share of cumulative investment from 27 percent at the end of FY 1974 to 50 percent by March 31, 1986 (see Table 7). Japan's direct investment in the 1970s centered on resource development and labor-intensive production, but in the 1980s turned to manufacturing in the industrial countries. Japanese investors are also moving aggressively into such areas as banking, finance, and insurance and real estate (see Table 8). The need to lower production costs in the face of the strong yen, though, will probably result in more investment in production facilities in developing countries.

Investment in the United States alone accounted for 44 percent of the total in FY 1985, while the amount invested in Asia and the Middle East declined. Japan has become a major investor in this country during the past few years (see Tables 9 and 10). Its investment position grew from $7.7 billion at year-end 1980 (7 percent of the U.S. total) to $19.1 billion at the end of 1985 (more than 10 percent). Real estate purchases by Japanese investors are increasingly significant; industry sources estimate that total investments in this country in this sector will rise from $1.5 billion last year to $3 to $5 billion in 1986.

Table 9: Foreign Direct Investment Position in the United States, Year-End 1981-1985

(in millions of dollars)

	1981	1982	1983	1984	1985
United Kingdom	$18,585	$28,447	$32,152	$38,387	$43,766
Netherlands	26,824	26,191	29,182	33,728	36,124
Japan	7,697	9,677	11,336	16,044	19,116
Canada	12,116	11,708	11,434	15,286	16,678
West Germany	9,459	9,850	10,845	12,330	14,417
Switzerland	5,474	6,378	7,464	8,146	11,040
Netherlands Antilles	8,232	9,190	9,948	10,935	10,603
France	5,876	5,708	5,726	6,591	6,295
OPEC Countries	3,336	4,045	4,039	4,892	4,560
Total	108,714	124,677	137,061	164,583	182,951
of which:					
Mining	2,152	1,876	1,928	3,920	4,070
Petroleum	15,246	17,660	18,209	25,400	28,123
Manufacturing	40,533	44,065	47,665	51,802	60,798
Wholesale Trade	16,012	18,397	21,031	24,455	27,514
Retail Trade	4,525	5,207	5,482	6,764	6,698
Banking	6,553	7,846	8,697	10,326	11,503
Finance	1,109	2,159	2,269	5,633	4,708
Insurance	7,086	7,928	8,665	8,922	11,069
Real Estate	8,964	11,520	14,636	17,761	18,557
Other	6,533	8,019	8,478	9,599	9,912

Source: Department of Commerce

Table 10: Japan's Foreign Direct Investment Position in the United States, Year-End 1981-1985

(in millions of dollars)

	1981	1982	1983	1984	1985
Total	$7,697	$9,677	$11,336	$16,044	$19,116
Mining	4	4	*	7	7
Petroleum	-78	113	-408	-88	31
Manufacturing	1,321	1,624	1,605	2,460	2,621
Food Products	165	182	186	186	149
Chemicals	249	252	283	252	267
Metals	121	117	140	541	575
Machinery	415	423	466	628	624
Other	372	649	530	853	1,005
Wholesale Trade	4,984	6,126	7,823	9,689	11,572
Retail Trade	67	151	234	252	250
Banking	1,180	1,325	1,384	1,853	2,176
Finance	*	-570	*	513	710
Insurance	*	169	182	138	122
Real Estate	305	396	515	744	1,054
Other	350	339	430	475	575

*Suppressed to avoid disclosure of data on individual companies.

Source: Department of Commerce

The threat of protectionism and the need to remain competitive in the face of the high yen will accelerate Japan's foreign investment in the years ahead. Calculated at an exchange rate of Y160=$1.00, the average Japanese manufacturing wage is the highest in the world -- $10.42 versus $9.52 in the United States -- according to estimates by the Industrial Bank of Japan. The Maekawa Report, released last April by an advisory committee to the prime minister, called for policies to double the outstanding balance of direct investment abroad over the next seven years. And the Economic Planning Agency projects that as a result of the yen's appreciation, 20 percent of the country's manufacturing output will take place abroad by the turn of the century, compared with the current level of only 2.4 percent.

Implications of Japan's Emerging Role

Japanese long-term net capital outflow, which totaled $86.4 billion in the first nine months of 1986, nearly double what it was for the same period a year earlier, is likely to remain strong in coming years. Individuals are shifting their funds from low-interest bank and postal savings deposits to higher-yielding securities, with a growing proportion invested in foreign assets. Japanese companies are relying on financial investments to soften the blow of lower export earnings. Recent regulatory changes insure that foreign investment will remain large. In September, for example, the limit on the ratio of foreign currency assets held by insurance companies was raised to 35 percent from the 25 percent ceiling set earlier in 1986. Foreign assets now account for about 18 percent of their total assets of Y53.9 trillion ($336.9 billion). And in April, the Posts and Telecommunications Ministry decided to end its limits on foreign securities purchases by the postal insurance fund, which had total assets of Y28 trillion ($175 billion) as of early 1986.

It is likely, therefore, that Japan's external assets in 1995 will reach the $1 trillion mark predicted by the Nomura Research Institute. As was true in Britain in the 19th century and the United States following World War II, the nation that is the chief supplier of capital to the world acquires tremendous power and influence. Although Japanese financial institutions will try to diversify away from dollar assets, a substantial share of Japanese funds will continue to be attracted to the highly developed capital markets of the United States. This is contributing to what Alan Greenspan, former chairman of the Council of Economic Advisers, termed "one of the most extraordinary integrations in the history of the world as a result of mutual dependence."

Inevitably, Japan's emergence as a major financial power has led to frictions with other countries. Because of their focus on market share rather than profits, Japanese firms have been accused of underpricing financial services. Last month Washington formally requested that Tokyo quickly permit American banks to enter the securities business in Japan. Moreover, 38 members of Congress urged the New York Federal Reserve Bank last year to reject the applications of the major Japanese securities firms to serve as primary dealers of Treasury securities until U.S. firms are accorded reciprocal treatment in Japan. And growing Japanese foreign direct investment is leading to fears, similar to those concerning Arab investors in the 1970s, that Japan will "own the world."

Japan is also playing a growing role in managing the developing countries' debt problems. Last month, Tokyo offered to lend $3.6 billion to the International Monetary Fund and increase its contribution to the International Development Agency (see JEI Report No. 37B, October 10, 1986). As commercial banks pull back from lending to developing countries, the Japanese government is being asked to make a greater contribution in this area. Recently, the Philippines requested a Y260 billion ($1.6 billion) loan. Some business leaders in both Japan and the United States have urged Tokyo to adopt a major aid initiative, similar to this country's Marshall Plan for postwar Europe.

International use of the yen for trade and investment and as a reserve currency will increase as a result of Japan's financial strength. At present, yen-denominated trade accounts for only 1 percent of total world trade. Only 3 percent of Japan's imports are valued in yen, while about 40 percent of the purchases made by West Germany, Britain and France are denominated in local currencies. Although the share of the yen in global official foreign exchange reserves went from 2 percent in 1976 to 5.2 percent in 1984, it is still small relative to the dollar's 65.1 percent share and the West German mark's 12 percent share. And only 7.4 percent of international bond issues in 1985 were denominated in yen compared to 59.3 percent denominated in dollars. According to a Nomura Research Institute survey of financial experts, a majority believe that international use of the yen in 10 years will be comparable to the current level of the mark.

Japan's role in the increasingly integrated world financial markets will continue to accelerate the liberalization of its domestic market. Under present banking regulations, the activities of commercial banks and securities firms are separated in order to prevent financial institutions from being exposed to the same company as both a lender and an equity investor. These rules are also intended to limit the power of Japanese banks over the manufacturing sector. But there is increasing pressure to end this distinction now that both Japanese banks and securities firms have been doing more of each others' kind of business in overseas markets. Moreover, Japanese banks complain that it is unfair to allow subsidiaries of foreign banks to engage in the securities business in Japan while they are excluded. Domestic banks have already begun trading government bonds and some experts think that the distinction will be abolished in the next few years.

Another result of Japan's emergence in world financial markets is Tokyo's growing importance as a major financial center increasingly linked to New York and London in a tripartite axis of global finance. Foreign financial firms have located in Tokyo to compete with Japanese firms and to tap surplus Japanese savings. The chairman of the Bank of Tokyo estimates that the American financial market is still the largest at $7.1 trillion, followed by Japan's $2.2 trillion and Britain's at $1.6 trillion. But Japan's expansion between 1970 and 1985 was a high 18.3 percent, with Britain next at 14.5 percent and the United States third at 8.8 percent.

According to a Nomura Research Institute survey, Tokyo compares favorably with New York and London in three areas important for an international financial center: a well-developed telecommunications network, market size and political stability. But the survey says that Tokyo is still handicapped by regulations governing foreign exchange transactions and capital movements and by a lack of personnel experienced in international finance. To enhance Tokyo's global role, it is important that internationally accepted trading rules and practices be adopted. This, in turn, will require the government to sacrifice some of its control over the financial market if Tokyo is to achieve its full potential as an international financial center.

For further information, contact Randall Jones.

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REPORT

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White House/Congress Trade Cooperation: Mixed Success Likely

Despite projections of "bipartisan cooperation" from members of the administration and Congress since the November 4 congressional elections, definite signs of conflict over trade issues are already apparent. As early as the morning after the election, White House chief of staff Donald Regan threatened a presidential veto of any protectionist trade bill. Sen. Robert Byrd (D, W.Va.), who is now unchallenged in his bid for majority leader, issued a warning of his own November 5 when he said that if a stalemate develops, it will be because the president makes trade reform confrontational. Legislation, he pledged, will reach the White House with or without the president's cooperation. It seems probable that basic differences of philosophy between Congress and the White House about trade issues will only intensify the conflict. However, the promised bipartisanship may develop in another area -- U.S. competitiveness in world markets.

Since Mr. Nakasone's first visit to China two and a half years ago, relations have boomed in terms of the volume and value of trade. This second visit will undoubtedly give new life to efforts to solve bilateral issues, particularly direct investment problems. In light of Beijing's continued efforts to modernize its economy and its military forces, links to the United States and Japan will continue to play a central role. Tokyo clearly hopes that solid trade and cultural relations will make this shift permanent.

Jon Choy

Japanese Investment In ASEAN Countries Likely To Increase

While the strong yen continues to pose debt repayment problems for Southeast Asian nations, the good news is that it has made Japanese firms more willing to invest in the region. According to a recent survey by the Promotion Center on Trade, Investment and Tourism of the Association of Southeast Asian Nations, Japanese investment in ASEAN countries will probably increase by at least 30 percent over the coming 12 months.

The survey polled 893 Japanese firms with overseas operations, of which 272 responded. Nearly 30 percent of the respondents chose the ASEAN region as their first investment choice. Moreover, 30 percent of those companies already operating there are considering expanding, 55 percent intend to maintain their present activities and only 10 percent are thinking of decreasing or completely withdrawing their investments.

If the survey is a good indicator it may signal a renewed regional emphasis by Japanese investors. ASEAN countries have been concerned that Japanese firms are turning toward the developed countries in recent years. Japanese investments in ASEAN countries have slipped to 16 percent of Japan's cumulative total, down from 20 percent in the late 1970s (see Table). Firms have been discouraged from setting up in some ASEAN countries by political and economic instability, bureaucratic obstacles and unfavorable tax structures; Western countries provide a better climate for investments.

Japan's Foreign Direct Investment in ASEAN Countries, FY 1984-FY 1985

(in millions of dollars)

Country	FY 1984	FY 1985	Cumulative March 31, 1986	Percent of Total
Indonesia	$374	$408	$8,423	10.1%
Singapore	225	339	2,269	2.7
Malaysia	142	79	1,125	1.3
Philippines	46	61	892	1.1
Thailand	119	48	760	0.9
Brunei	5	1	107	0.1

Source: Ministry of Finance

Nonetheless, foreign and domestic groups have put pressure on Tokyo to steer investments toward the ASEAN region. The government has acknowledged the merits of such a move, as evidenced by the Ministry of International Trade and Industry's August announcement of a program to help the ASEAN countries develop export-oriented industries through increased Japanese investment (see JEI Report No. 32B, August 29, 1986). More recently, a group of Japanese ambassadors to East Asia and other Pacific countries urged Tokyo to be more responsive to the region's expectations.

During a visit to Tokyo last month, Singapore's Prime Minister Lee Kuan Yew brought up the subject, saying that he was concerned about Japanese investment going to the developed countries. He asked for increased investment in Singapore and ASEAN, and suggested that Japanese firms initiate "buy-back" arrangements with their affiliates in Singapore. He also expressed a desire for "design, development and higher value-added work," not only offshore assembly. Finally, according to the Japan Economic Journal, the United States has also asked Tokyo to extend more aid and investment to Asian countries in order to counter Soviet influence.

In short, both political pressures and economic advantages offered by the strong yen will inspire a greater Japanese presence in the ASEAN region, at least in the immediate future. However, business executives maintain that ASEAN countries should improve their investment climates as well -- especially with regard to infrastructure, government regulations and tax structures. While there has been some positive feedback from Thailand, it is still unclear how quickly the other countries in the region will respond to this request.

Eileen Marie Doherty

Notes

- Japan and the United States agreed November 5 to extend an agreement insuring open and nondiscriminatory purchasing policies by Nippon Telegraph and Telephone Corp. for another three years. The 1981 accord, extended once before in 1984, opens NTT's bidding procedures to foreign firms and gives them an opportunity to develop equipment from scratch in cooperation with the telecommunications giant (see JEI Report No. 5B, February 3, 1984). The pact was to expire December 31 but Tokyo readily agreed to extend it as part of its commitment to opening the domestic telecommunications market to foreign firms. The United States sought to extend the procurement pact to one of NTT's private competitors in the common carrier market (Daini Denden Inc.), but Tokyo pointed out that DDI is a wholly private corporation.

- The Ministry of Finance set the price of one share of Nippon Telegraph and Telephone Corp. at Y1,197,000 ($7,481.25 at Y160=$1.00) in preparation for the sale of 1.65 million shares to individual investors. MOF arrived at this eye-opening price (par value is Y50,000 or $312.50) by auctioning 200,000 shares to institutions and wealthy individuals on October 24 (see JEI Report No. 40B, October 31, 1986). The ministry will now accept bids for single shares from individuals from November 17-26. Should there be more bids than shares, which is highly likely, MOF will hold a lottery for the coveted stock and will announce the winners by the end of the year. This is the first of at least four sales of NTT shares that Tokyo will offer as part of its plan to sell up to two-thirds of the previous government monopoly.

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Report On Economic Restructuring Stresses Employment Measures

A report released by a government advisory council December 1 called for industrial restructuring and continued economic growth to trim Japan's huge trade surplus and improve the quality of life. It also emphasized, though, the importance of measures to insure sufficient employment opportunities during the restructuring, reflecting the government's concern over rising unemployment figures. Bunpei Otsuki, chairman of the Japan Federation of Employers' Associations, warned recently that the unemployment rate will climb from September's 2.8 percent to the 6-7 percent range if current trends continue.

The advisory council, chaired by former Bank of Japan governor Haruo Maekawa, prepared the study as an extension of the Maekawa report submitted to the prime minister April 7 (see JEI Report No. 14B, April 11, 1986). The council's final recommendations will be submitted next spring.

to threaten to filibuster any trade bill that did not limit textile-apparel imports. Having already proclaimed trade as a priority for the Commerce Committee, the senator is likely to emphasize textile legislation, but will probably not limit himself to that issue. Some observers are predicting that he may even attempt to inaugurate a rivalry with the Finance Committee for jurisdiction on trade matters, similar to the House competition between Ways and Means trade subcommittee chairman Sam Gibbons (D, Fla.) and Energy and Commerce chairman John Dingell (D, Mich.).

On the other side of Capitol Hill, House members are gearing up to renew their drive for a trade bill. Rep. Jim Wright (D, Tex.), the new Speaker of the House, has said that a modified version of HR 4800 will be introduced January 6 -- the day Congress convenes -- as HR 3. Preliminary indications are that the House and Senate are working independently on trade legislation; the lack of communication between the two chambers may pave the way for a protracted conference later in the session. For its part, the administration has not said whether it plans to cooperate with Congress and all indications are that legislators are forging ahead without close White House consultations.

Eileen Marie Doherty

Japan Agrees To Restrain Machine Tool Exports

Another item can be crossed off the list of outstanding bilateral trade issues. On November 20 trade negotiators for Japan and the United States initialed an agreement limiting U.S.-bound shipments of six lines of Japanese-made machine tools for five years effective January 1, 1987. The restraint arrangement's final details were worked out six months to the day after President Reagan took the unprecedented step of asking Japan and three other foreign suppliers (West Germany, Switzerland and Taiwan) to voluntarily restrict machine tool exports for national security reasons (see JEI Report No. 20B, May 23, 1986). By coming to terms with Washington just before the White House deadline for an agreement, Tokyo avoided a threatened formal finding under Section 232 of the 1962 Trade Expansion Act that imports of machine tools from Japan undermine the viability of an industry essential to this country's security and the accompanying presidential decision to roll back shipments by bigger margins than the negotiated cutbacks.

The details of the restraint arrangement with Japan are still confidential, mainly because a final agreement has not been signed but also because negotiations with the three other suppliers targeted by the administration are continuing. From press leaks on both sides of the Pacific, however, it is possible to piece together a fairly complete picture of the pact. According to this information, Tokyo will cap 1987 shipments of machining centers at 2,800 units (down 22.3 percent from 1985 exports), computer numerically controlled lathes at 3,200 units (down 16.5 percent) and CNC punching and shearing machines at 250 units (a cut of roughly 40 percent).

With exports held at these volumes, government and industry analysts project that Japan's share of the U.S. market for high technology machining centers and CNC lathes will return to the 1981 level -- the last big-profit year for the boom-and-bust domestic machine tool industry. For machining centers this would mean a rollback in market penetration from 1985's 73.5 percent to 51.5 percent and for CNC lathes a cut from 67.1 percent to 57.5 percent. Washington also expects shipments of CNC punching and shearing machines in 1987 to be equivalent to 1981's market share of 19.3 percent or well below the 1985 figure of 43.1 percent.

In the three other product lines covered by the restraint agreement -- manual lathes, manual punching and shearing machines and milling machines, the Ministry of International Trade and Industry will monitor exports destined for the United States. The apparent objective here is to keep 1987 deliveries close to the volumes shipped in 1985 (see Table). In that year Japanese suppliers controlled less than 10 percent of the American market in each of the three lines.

Japan's Exports of Selected Machine Tools to the United States, 1981-85

	1981	1982	1983	1984	1985
Quantity (units)					
Machining Centers	2,180	1,728	1,957	2,858	3,602
Numerically Controlled Lathes	3,878	2,350	1,781	3,201	3,834
Other Lathes	642	449	200	254	331
Numerically Controlled Milling Machines	364	184	180	240	254
Other Milling Machines	495	1,693	1,570	2,416	2,168
Shearing and Punching Machines	1,462	1,040	2,369	2,855	2,559
Value (thousands of dollars*)					
Machining Centers	$222,164	$165,897	$170,581	$254,979	$313,498
Numerically Controlled Lathes	315,673	178,490	114,919	192,570	227,341
Other Lathes	22,444	18,228	5,250	6,515	2,801
Numerically Controlled Milling Machines	26,907	10,751	8,178	29,366	30,504
Other Milling Machines	11,456	5,697	1,994	4,010	2,981
Shearing and Punching Machines	34,230	21,275	21,006	31,549	39,254
Total	632,874	400,338	321,928	518,989	616,379

*The following average annual exchange rates, calculated by the Ministry of Finance, were used to convert the yen export figures: 1981, Y219.90; 1982, Y248.33; 1983, Y237.52; 1984, Y236.95; and 1985, Y240.29.

Source: Japan, Ministry of Finance, Japan Exports and Imports: Commodity by Country

There are reportedly no numbers in the pact for exports of machining centers, CNC lathes and CNC punching and shearing machines after 1987. This fall U.S. trade negotiators indicated that the restraint levels would be adjusted at least annually and perhaps quarterly based on projections of apparent domestic consumption. If this information is correct, the machine tool arrangement will work like the one governing Japan's U.S.-bound exports of steel mill products (see JEI Report No. 11B, March 22, 1985). In short, shipments in the agreement's out years could be higher or lower than in 1987.

Another question mark is the treatment of machine tool parts shipped to the United States for assembly by the growing number of Japanese builders with American plants. What Japan classifies as kits or knocked-down machines in its export statistics are definitely subject to the shipment ceilings since they are viewed as no different than finished products. But with the U.S. assembly operations of Japanese companies incorporating more domestic parts and components in their machine tools in response to the strong yen, these products might be treated as American-made and placed outside the export limits.

The uncertainty about this and some other details is one reason industry reaction to the agreement has been so muted, both here and in Japan, but there are more basic explanations. Japanese machine tool builders were reconciled to export limits of one kind or another once President Reagan made the decision to help the struggling U.S. industry; since the only alternative to "voluntary" restraints was a 232 finding, they were relieved that Tokyo and Washington came to terms. The fact that the agreement is not retroactive to May or even the beginning of 1986 -- a surprising administration concession -- also made the settlement option more acceptable to the Japanese industry.

At first glance, the low-key response of U.S. machine tool companies to the prospect of five years of controlled competition from their primary rivals is more puzzling than the subdued protest from Japanese suppliers since domestic builders have been trying to gain import relief for the last four years. Here, too, there is a straightforward explanation. Industry executives and congressional supporters of protection for machine tool makers maintain that the restraint arrangement is a case of too little, too late (see JEI Report No. 31B, August 22, 1986).

Susan MacKnight

Notes

- On November 19 the U.S. Federal Reserve Board approved Sumitomo Bank, Ltd.'s purchase of a minority interest in Goldman, Sachs & Co.'s profits with some restrictions. The Japanese bank sought to invest $500 million for a non-voting position in Wall Street's largest independent brokerage house, giving it a 12.5 percent stake in Goldman, Sachs' annual profits by 1988 (see JEI Report No. 41B, November 7, 1986). The Fed governors, however, were concerned that this would give Sumitomo undue influence over Goldman, Sachs' activities, noting that "The total investment would exceed 25 percent of Goldman's total equity," which was approximately $1.3 billion at the end of May 1986.

Therefore, the Fed placed the following restrictions on the agreement: Sumitomo's total investment will be limited to 24.9 percent of the total partners' equity; Sumitomo will not acquire any Goldman stock or have any representatives on the board of directors; the two will conduct business relations at arm's length; furthermore, they will not increase their mutual business dealings and will not solicit business for each other; no employee exchanges will be allowed; and Sumitomo must "enhance its capital position by an amount that will substantially offset the funds being invested in Goldman, Sachs." The two will refrain from establishing joint ventures in London and Tokyo for now.

Despite these restrictions, both firms accepted the Fed's ruling. A senior partner at the American brokerage concern said that the firm would try to raise its partners' equity enough to allow Sumitomo to invest the full $500 million by 1988. The president of Sumitomo took a long-term view, saying that he hoped that some of the restrictions would be eased in the future. The two sealed the agreement on November 28 as planned.

Corrections

In JEI Report No. 39A, October 24, 1986, it was incorrectly reported that Japan's official development assistance was increased by 10 percent in the FY 1986 budget. Budget guideline figures slated a 10 percent hike, but the final budgetary figure was 7 percent.

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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U.S. TELECOMMUNICATIONS EXPORTS TO JAPAN: THE DEREGULATED DIFFERENCE

Summary

Tokyo's impending deregulation of the domestic telecommunications equipment and services market was the subject of intense negotiations with Washington in 1984-85. With Japanese firms enjoying booming sales of telecommunications equipment in the U.S. market, Washington sought similar opportunities for domestic companies in Japan. The negotiations were lengthy and tense, but ultimately very successful; all sides agree that U.S. exports of telecommunications equipment and expertise have benefited from deregulation. This report describes the deregulated Japanese market, the strategies U.S. firms have pursued and the resulting trade changes.

Introduction

On April 1, 1985 Japan's domestic telecommunications equipment and services market was opened to private-sector competition. This dramatic shift, which nearly doubled the size of the market overnight, had domestic origins. Japanese telecommunications equipment makers had reached the state of the art in some areas and were eager to expand sales at home and abroad. Similarly, customer needs had grown faster and more sophisticated than Nippon Telegraph and Telephone Public Corp.'s ability to meet them, leaving users dissatisfied. But the deregulated market's final form was heavily influenced by American thinking. It is undoubtedly true that Tokyo used the breakup of American Telephone & Telegraph Co. as a model, both in terms of what to do and what not to do. But it was the outcome of the intense bilateral MOSS (market-oriented sector-selective) negotiations that had the greatest impact on areas important to U.S. exporters.

The New Market: Deregulation and Liberalization

Japan's deregulation plan can be divided into two main parts -- the privatization of the government telecommunications monopoly and the entry of private firms into the telecommunications services market -- and two related issues.

NTT Privatization - On April 1, 1985 Nippon Telegraph and Telephone was transformed from a public enterprise into a joint stock corporation, dropping the word "Public" from its name in the process. The new NTT was capitalized at Y780 billion ($4.9 billion at Y160=$1.00), far above the Y18.8 billion capitalization at its inception in 1952. Initially, all NTT shares were held by the government. Tokyo is in the midst of selling off the first bloc of stock to the public, the first step toward putting up to two-thirds of NTT into private hands. (Foreigners are not allowed to own shares, however.) The new NTT's budget and business plan must be authorized by the government, a simpler procedure than securing Diet approval. Although it is still obliged to provide nationwide telephone service and conduct research and development in telecommunications, NTT gained the ability to change its service rates (with authorization from the Ministry of Posts and Telecommunications) and the freedom to invest in areas other than telecommunications. Finally, the board of directors will be elected by the shareholders rather than appointed by MPT, although the ministry's authorization is still necessary for any board changes.

NTT is also required to adhere to the terms of the 1981 procurement agreement negotiated between the United States and Japan, which was recently extended through 1989 (see JEI Report No. 42B, November 14, 1986). It will continue to facilitate equipment bids from foreign suppliers and make its long-term equipment and technology development programs open to them. In fact, NTT's president has repeatedly stated that the firm will buy the best products regardless of their national origin.

While the Japanese telecommunications reorganization is not quite as drastic as the breakup of AT&T -- for instance, local and long-distance services are still under its domain -- this does not mean that NTT faces less pressure from new private competitors than AT&T is experiencing.

Market Deregulation - The legislation mandating reform specifies two types of telecommunications businesses. Firms that build their own telecommunications circuit facilities are classified Type I. These firms must obtain MPT's permission to begin and cease operations as well as to change their tariff schedules. They must also heed any government orders to amend the tariff rates, to "improve business activities" and to "interconnect or share telecommunciations facilities." Foreign control of Type I firms is not permitted.

All other telecommunications firms are classified Type II. This does not mean Type II firms cannot be common carriers. Companies can rent or lease

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circuits from a Type I firm and provide voice/data services to the general public on a nationwide scale. These services for "many and unspecific persons with large-scale network" are considered Special Type II firms. All others are General Type IIs. Special Type IIs must register with MPT to begin operations, but need only notify the ministry if they intend to go out of business or change rates. General Type IIs are expected to notify MPT of their plans in all instances. All Type II firms are subject to government oversight.

Telecommunications Terminal Equipment Standards and Approval - This was one of the most difficult areas for Japan and the United States to negotiate. MPT, in its traditional role as guarantor of quality and satisfaction to the Japanese consumer, sought to establish strict standards across a broad range of areas. U.S. negotiators wanted just the opposite: limiting MPT's role to insuring only that terminal equipment does not harm the network. They contended that all other performance and appearance standards were unnecessary. MPT eventually agreed to the majority of U.S. requests. Technical standards were reduced from 53 to 21. The private Telecommunications Technology Committee was established in October 1985 to draft all subsequent standards. (Foreign firms are members of TTC.) The Japan Approvals Institute for Telecommunications Equipment was founded as an independent testing and certification body to approve equipment from all companies (including NTT), and it agreed to accept foreign test data for approval purposes. Finally, the approval process was made transparent and simplified.

Cellular Telephone Service - Because cellular (mobile) telephone service relies on wireless transmission, which was outside the realm of the deregulation legislation, the United States initiated discussions on amendments to Japan's Radio Law in an effort to liberalize this lucrative NTT monopoly. Although mobile telephones have been available in Japan since 1979, and pocket pagers since 1969, the market's potential remained largely untapped. Starting with 1,557 users in one city in 1979, cellular telephone service had expanded to 473 cities and 61,786 users by the end of 1985, an average growth rate of just over 100 percent. Although not as spectacular, the growth of paging receivers was estimated by MPT at 14.3 percent from fiscal 1984 to fiscal 1985, bringing the total number in use to approximately 2.2 million.

The issue was complicated by the fact that Tokyo had allocated portions of the radio spectrum differently than in the United States and that NTT's cellular telephone format was different from the U.S. standard. This meant that foreign firms had to alter their equipment for sale in Japan, which they were reluctant to do. MPT thus asked the TTC to examine whether Japanese and foreign standards could coexist. The council reported in April 1986 that this was technically feasible.

MPT then agreed to amend the Radio Law to allow foreign firms to obtain a license to operate a private radio facility for mobile communications on land, effective July 1, 1986. The Radio Facilities Technical Compliance Certification System was simplified to limit its standards to those necessary to "avoid interference with other users" and to encourage "the efficient use of frequencies." The minimum set of standards was reduced from ten to one; the nine others are voluntary. Approval procedures followed by the Radio Equipment Technical Certification Institute were simplified and foreign test data are now acceptable.

Administrative Policy - In order to make MPT's administrative and policy processes more transparent to foreign firms, Japanese employees of foreign-affiliated companies have been invited to participate in MPT's advisory councils, including the ministry's Telecommunications Council and the private TTC. In addition, MPT has pledged to continue working toward greater transparency in all approval and standard-setting procedures. The ministry will also improve the distribution of information to foreign firms as well as continue to seek their opinions.

Import Promotion - Tokyo has taken two other steps specifically aimed at encouraging imports of foreign products. As part of a July 30, 1985 market liberalization package, tariffs on five items -- telephone instruments (4.2 percent), telegraph equipment (3.6 percent), electronic switches (5.7 percent), current-carrier equipment (3.6 percent) and radio communications equipment (4 to 5.1 percent) -- were eliminated at the end of 1986. To encourage small businesses to broaden their purchasing practices, special depreciation rates and tax exemptions were introduced for imported mechanical or electronic products. In contrast to the normal first-year depreciation allowance of 30 percent, small firms can depreciate 36 percent of the cost of qualified imported items. In addition, buyers of imported high technology equipment qualify for an 8.4 percent tax exemption as opposed to 7 percent for domestic products.

The New Market: Foreign Strategies

Unlike earlier regulatory disclosures, U.S. firms were aware of the impending telecommunications deregulation in time to pursue a range of market entry strategies while at the same time developing the personal ties that are so important in penetrating the Japanese market.

The most common approach, and one followed almost exclusively by small firms, is to appoint an established Japanese firm as sales agent. It is not surprising to find Japanese trading companies (sogo shosha) playing a central role in this mode. The Japanese trading giants have been seeking ways to expand beyond their traditional emphasis on bulk industrial and agricultural materials, and their focus has been on high technology, especially communications technology. They have been actively searching for innovative, advanced foreign products since the beginning of the decade and small American firms have been favorite partners.

Another popular entry method is a joint venture with a Japanese firm. The foreign partner usually supplies the core technology while the Japanese partner brings the product into accord with Japanese standards and handles distribution and sales. Both small and large firms alike have found this a useful route, but large firms have found it particularly advantageous in entering a broad range of market segments. The activities of IBM Japan Ltd. epitomize this approach. It has pursued everything from small-scale value-added networks to the manufacture of various types of telecommunications equipment via joint ventures, and has even linked up with NTT in several fields.

The remaining two options -- establishing a wholly owned subsidiary or marketing operation and buying an existing Japanese firm -- have been much less common. It is difficult for a newcomer operating on its own to establish credibility with customers and distributors. This is not an insurmountable obstacle, but a firm must take a long-term view if the strategy is to succeed.

Buyouts are still extremely rare in Japan, and even rarer when a foreign firm is involved. Japanese business practices are simply not amenable to this approach.

Although it no longer monopolizes the domestic telecommunications market, NTT still accounts for nearly half of all equipment purchases. A handful of foreign firms have therefore targeted NTT as a customer for their most advanced products. Although American firms have sold NTT an assortment of off-the-shelf products, Northern Telecom Inc. appears to have made the greatest effort to become an accepted NTT supplier. Its digital private branch exchange system was one of the first major products to be developed in cooperation with NTT (the Track III-A approach) and to receive NTT's type approval. NTT's information network service (INS), the Japanese counterpart to the American integrated services digital network (ISDN), has also attracted interest from several American firms, including IBM Japan.

The Deregulated Difference

A survey of JEI's monthly publication, the Japan-U.S. Business Report, reveals some important shifts in the approach used by foreign firms entering the Japanese telecommunications market since 1983. At that time, nearly all agreements between U.S. and Japanese firms were simple sales agency pacts. The exceptions to this rule were those U.S. affiliates already well established in Japan, IBM for example. Beginning in 1984, the number of joint ventures began accelerating; wholly owned subsidiaries have become more visible only within the last year. The activity is so fast and furious that a score-card is necessary to keep all the players straight.

According to the Ministry of Posts and Telecommunications, 1,151 new types of equipment were approved for use in fiscal 1985 (ended March 31, 1986); telephone handsets accounted for 31 percent of the total; key telephones for another 16 percent; modems, 9 percent; data terminals another 8 percent; and private-branch exchanges 4 percent. Of this total, JATE approved 174 different types of foreign-made terminal equipment, almost six times the number approved the previous fiscal year (25). The United States led the pack with 103 of the 174, followed by Taiwan (35), Italy (13) and Hong Kong (13).

MPT reports that five new Type I firms (three of which have already begun operations) and 209 Type II companies were registered in fiscal 1985. The ministry does not have figures on the percentage of foreign versus domestic firms. These new entities have drastically altered the shape of the market. MPT estimates that NTT accounted for 48.6 percent of FY 1985's Y1,247 billion ($7.8 billion) equipment market, the private sector another 41.5 percent and the government the remaining 9.9 percent. Over the past five fiscal years, the ministry asserts, private demand for telecommunications equipment has grown by 6 percent annually while demand by NTT has fallen 5.2 percent. This decline, however, has not affected purchases from abroad. The telecommunications giant bought Y37 billion ($231.3 million) from abroad in FY 1985, a gain of Y1.9 billion ($11.9 million) over the previous year. Sales of U.S. gear to NTT have been flat for the past three fiscal years, however -- Y31.2 billion ($195 million) in FY 1983, Y31.8 billion ($198.8 million) in FY 1984 and Y32 billion ($200 million) last fiscal year.

It is difficult, if not impossible, to accurately gauge the foreign share in Japan's growing telecommunications market. It can be asserted that foreign firms are present in nearly every market segment. AT&T International Inc., Rolm Corp., Digital Switch Corp., IBM Japan and Northern Telecom all have developed solid beachheads in the telephone, PBX and transmission equipment areas. Corning Glass Works, GTE Corp., E.I. DuPont de Nemours & Co., Gould Inc. and a handful of smaller American firms have entered the fiber-optic market. Motorola Inc. will supply equipment to a Japanese consortium out to compete with NTT in the pocket paging and mobile telephone businesses. The private satellite communications field is composed entirely of tie-ups between U.S. and Japanese firms. And finally, American firms are beginning to tap the research and development potential of the Japanese market: Pacific Telesis International inked an agreement with NTT in 1985 to exchange personnel, and Bell Laboratories Inc. opened a liaison office in Japan in 1986.

The situation is also difficult to evaluate in terms of trade flows because the trade statistics do not distinguish telecommunications products from other closely related items. According to the Commerce Department, U.S. exports of telecommunications gear to Japan rose by 17.3 percent in 1983 (to $207 billion), 1.3 percent in 1984 ($210 billion), and 7.9 percent in 1985 ($226 billion), a mixed record when compared to overall U.S. export growth of 4.3 percent, 7.3 percent and -3.4 percent, respectively. For the first eight months of 1986, Commerce calculated a rise in shipments of these products of 11.6 percent.

Data compiled from U.S. and Japanese trade publications confirm this assertion (see Tables 1-4). Although the two sets of data are not directly comparable, both show that U.S. exports have performed well both in terms of volume and value. Exchange rate considerations are not a factor in the 1982-85 figures, since the average yen-dollar rate was relatively stable. When comparing the data for the first seven or eight months of 1984-86, however, it is important to realize that the yen has appreciated significantly (averaging, according to the Ministry of Finance, Y232.89, Y251.12 and Y176.13, respectively, for import transactions). Therefore, even if volume remained constant between 1985 and 1986, the dollar value would still have increased by 42.6 percent due to exchange rate changes.

Outlook

An advisory body to MPT predicts that the total telecommunications equipment and services market will grow to Y10.4 trillion ($65 billion) by 1990, and Y19 trillion ($118.8 billion) by the end of this century. Even if these figures prove to be optimistic, it is still obviously worthwhile for foreign firms to try to garner a share of the action. The overview of foreign activity shows that American companies have made a good start at developing a solid market position. Although MPT is attempting to limit the number of firms in the satellite communications market and the pocket pager market, it appears that entry into other segments is relatively free.

From the foreign viewpoint, there are still some areas that could be improved. Government procurement remains an area of uncertainty. MPT's registration procedures and classifications, though greatly simplified, are still more complex than those used in the United States. NTT remains a difficult customer, and Tokyo is sensitive about meddling in the affairs of the "private" firm. In general, the atmosphere has improved, but is still not perfect in the eyes of some Americans. Although this is cause for some concern given the 100th Congress's intention to pass new trade legislation, the outlook must be considered positive. The weaker dollar should add more weight to the American push into the Japanese telecommunications market, but it appears that deregulation is the key difference.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Japan's Imports of Selected Communications Equipment, 1982-1985

(in indicated quantity units and ¥1,000)

Trade classification number, item and units	1982 Quantity United States	1982 Quantity Total	1982 Value United States	1982 Value Total	1983 Quantity United States	1983 Quantity Total	1983 Value United States	1983 Value Total
85.13-								
110 Carrier current line systems, No.	7,116	9,109	¥2,754,449	¥3,446,182	10,774	13,644	¥3,443,110	¥4,171,954
121 Electronic telephonic switchboards and exchanges, No.	56	118	256,102	1,884,559	156	351	1,219,844	2,077,755
122 Other telephonic switchboards and exchanges, No.	--	10	--	4,291	2	270	508	1,239
129 Other electric line telephonic gear, No.	7,858	55,354	256,382	633,605	8,405	224,401	320,354	1,412,052
130 Electric line telegraphic gear, No.	3,452	3,830	294,358	478,241	19,517	19,688	148,146	202,227
210 Parts for electric line telephonic and telegraphic gear, Kg.	49,883	249,967	7,355,494	8,308,904	46,031	296,594	7,167,904	8,156,932
220 Multipurpose parts, Kg.	1,406	3,070	51,256	84,369	2,448	10,927	125,839	144,956
Total	69,771	321,458	10,968,041	14,840,151	87,333	565,875	12,425,705	16,167,115
85.15-								
424 VHF transmitters and transmitter-receivers, No.	493	4,460	12,673,005	13,100,783	644	23,985	11,768,408	12,339,810
425 Other transmitters and transmitter-receivers, No.	57,943	60,720	2,423,329	2,545,138	75,328	81,931	3,069,194	3,136,446
510 Parts of radiotelegraphic-radiotelephonic, radio broadcasting and television transmission and reception gear; and television cameras, Kg.	70,361	1,323,486	3,249,465	11,606,174	61,788	1,662,038	3,454,064	12,567,277
Total	128,797	1,388,666	18,345,799	27,252,095	137,760	1,767,954	18,291,666	28,043,533
85.21-								
140 Tubes for telephonic-telegraphic, radio broadcasting and television transmission gear (excluding receiving tubes), No.	83,401	87,999	668,934	766,730	29,669	31,877	841,194	968,217
85.23-								
120 Communications cable, Kg.	--	--	--	--	76,477	100,929	211,581	342,989
121 Copper communications cable, Kg.	21,495	76,537	164,190	476,759	--	--	--	--
129 Other communications cable, Kg.	656	780	113,648	114,059	--	--	--	--
Total	22,151	77,317	277,838	590,818	76,477	100,929	211,581	342,989
90.13-								
091 Other optical appliances and instruments, No.	21,303	168,866	3,863,178	4,649,541	14,945	193,028	4,120,590	4,901,828
099 Parts and accessories for optical appliances, instruments and lasers, Kg.	13,103	16,644	1,209,793	1,300,458	29,416	34,031	1,963,061	2,230,675
Total	34,406	185,510	5,072,971	5,949,999	44,361	227,059	6,083,651	7,132,503
90.25-								
030 Instruments and gear for checking quantities of heat, light or sound and parts, Kg.	324	347	25,145	43,536	499	1,913	33,243	88,736
90.28-								
121 Spectrum analyzers	656	2,667	2,856,815	2,905,013	538	546	2,566,409	2,594,149
Total	339,506	2,063,964	38,215,543	52,348,342	376,637	2,696,153	40,453,449	55,337,242

Table 1 (continued)

(in indicated quantity units and Y1,000)

Trade classification number, item and units	1984				1985			
	Quantity		Value		Quantity		Value	
	United States	Total	United States	Total	United States	Total	United States	Total
85.13-								
110 Current carrier line systems, No.	17,508	22,139	Y4,211,646	Y4,979,579	33,082	41,462	Y5,689,992	Y6,427,261
121 Electronic telephonic switchboards and exchanges, No.	188	262	1,641,081	1,754,024	263	1,074	2,356,737	2,459,825
122 Other telephonic switchboards and exchanges, No.	4	66	1,662	10,445	9	464	843	29,927
129 Other electric line telephonic gear, No.	66,789	895,747	1,034,223	2,708,700	96,399	1,541,764	1,644,761	4,262,396
130 Electric line telegraphic gear, No.	23,613	24,543	146,488	208,245	34,320	36,505	433,902	566,466
210 Parts for electric line telephonic and telegraphic gear, Kg.	62,950	261,471	10,246,983	11,101,686	70,874	232,891	14,234,238	15,276,851
220 Multipurpose parts, Kg.	9,491	28,854	921,977	1,070,942	4,578	20,533	402,858	431,628
Total	180,543	1,233,082	18,204,060	21,833,621	239,525	1,874,693	24,763,331	29,454,354
85.15-								
424 VHF transmitters and transmitter-receivers, No.	1,345	16,548	5,080,857	5,496,710	4,390	17,559	1,014,077	1,252,727
425 Other transmitters and transmitter-receivers, No.	74,666	85,008	2,887,047	3,029,256	75,165	80,297	2,456,717	2,563,067
510 Parts of radiotelegraphic-radiotelephonic, radio broadcasting and television transmission and reception gear; and television cameras, Kg.	90,991	1,769,293	2,514,668	12,237,589	77,035	2,293,564	3,354,035	16,554,036
Total	167,002	1,870,849	10,482,572	20,763,555	156,590	2,391,420	6,824,829	20,369,830
85.21-								
140 Tubes for telephonic-telegraphic, radio broadcasting and television transmission gear (excluding receiving tubes), No.	19,747	21,871	875,001	1,049,476	12,890	14,659	865,811	1,094,475
85.23-								
120 Communications cable, Kg.	26,162	424,454	136,809	451,780	14,894	214,012	166,194	295,639
90.13-								
091 Other optical appliances and instruments, No.	26,097	675,529	5,458,163	6,525,199	26,450	1,354,851	7,022,062	8,903,517
099 Parts and accessories for optical appliances, instruments and lasers, Kg.	24,931	32,159	1,956,415	2,095,231	46,546	55,624	2,781,054	2,988,395
Total	51,028	707,688	7,414,578	8,620,430	72,996	1,410,475	9,803,116	11,891,912
90.25-								
030 Instruments and gear for checking quantitites of heat, light or sound and parts, Kg.	985	1,368	42,568	61,637	1,058	2,525	33,324	75,702
90.28-								
121 Spectrum analyzers	753	760	3,378,761	3,395,187	655	668	2,958,862	2,985,905
Total	446,220	4,260,072	40,534,549	56,175,686	498,608	5,908,452	45,415,467	66,167,817

Source: Ministry of Finance, Japan Tariff Association

Table 2: Japan's Imports of Selected Communications Equipment, January-August, 1983-1986

(in indicated quantity units and Y1,000)

Trade classification number, item and units	1983				1984			
	Quantity		Value		Quantity		Value	
	United States	Total	United States	Total	United States	Total	United States	Total
85.13-								
110 Carrier current line systems, No.	6,660	8,109	Y2,221,048	Y2,575,913	12,236	15,165	Y2,556,353	Y3,102,829
121 Electronic telephonic switchboards and exchanges, No.	96	289	657,759	1,418,708	112	127	942,366	1,001,940
122 Other telephonic switchboards and exchanges, No.	--	--	--	--	3	65	1,203	9,986
129 Other electric line telephonic gear, No.	5,888	114,587	275,019	836,947	9,671	371,723	253,616	1,110,058
130 Electric line telegraphic gear, No.	8,894	9,002	95,978	143,057	13,703	13,804	93,401	141,620
210 Parts for electric line telephonic and telegraphic gear, Kg.	27,477	246,297	4,293,404	5,016,864	34,849	87,093	5,290,506	5,690,682
220 Multipurpose parts, Kg.	1,444	1,771	38,131	44,152	8,060	11,842	827,197	919,907
Total	50,459	380,005	7,581,339	10,035,641	78,634	499,819	9,964,642	11,977,022
85.15-								
424 VHF transmitters and transmitter receivers, No.	501	12,189	1,516,514	1,819,148	662	13,254	4,862,700	5,218,703
425 Other transmitters and transmitter-receivers, No.	50,696	55,615	2,164,474	2,222,504	56,621	64,879	1,800,997	1,865,167
510 Parts of radiotelegraphic-radiotelephonic, radio broadcasting and television transmissions and reception gear; and television cameras, Kg.	48,467	1,126,308	2,238,718	8,028,227	67,628	1,081,065	1,686,138	7,718,507
Total	99,664	1,194,112	5,919,706	12,069,879	124,911	1,159,198	8,349,835	14,802,377
85.21-								
140 Tubes for telephonic-telegraphic, radio broadcasting and television transmission gear (except receiving tubes), No.	24,817	25,456	434,656	521,773	14,515	15,850	585,176	715,876
85.23-								
120 Communications cable, Kg.	68,542	92,105	168,808	292,845	16,090	397,667	84,273	375,491
90.13-								
091 Other optical appliances and instruments, No.	9,620	88,156	2,481,115	2,995,995	20,542	577,841	3,289,047	3,972,561
099 Parts and accessories for optical appliances, instruments and lasers, Kg.	23,766	26,879	1,456,780	1,673,690	14,363	19,441	1,111,466	1,220,966
Total	33,386	115,035	3,937,895	4,669,685	34,905	597,282	4,400,513	5,193,527
90.25-								
030 Instruments and gear for checking quantities of heat, light or sound and parts, Kg.	355	1,221	25,737	45,694	523	779	28,394	39,660
90.28-								
121 Spectrum analyzers	365	372	1,659,044	1,686,391	468	472	2,202,505	2,209,726
Total	277,588	1,808,306	12,145,846	36,903,247	270,046	2,671,067	25,615,338	35,313,679

Table 2 (continued)

(in indicated quantity units and Y1,000)

Trade classification number, item and units	1985				1986			
	Quantity		Value		Quantity		Value	
	United States	Total	United States	Total	United States	Total	United States	Total
85.13-								
110 Carrier current line systems, No.	27,407	30,834	Y3,988,719	Y4,463,941	12,591	21,376	Y3,230,838	Y4,024,993
121 Electronic telephonic switchboards and exchanges, No.	211	492	2,000,016	2,039,723	159	629	1,714,913	1,962,880
122 Other telephonic switchboards and exchanges, No.	1	452	454	13,911	--	--	--	--
129 Other electric line telephonic gear, No.	101,624	1,009,614	1,715,242	3,420,090	6,187	924,512	274,332	2,169,627
130 Electric line telegraphic gear, No.	23,453	23,579	212,203	280,070	33,113	36,191	496,756	1,036,392
210 Parts for electric line telephonic and telegraphic gear, Kg.	43,939	147,906	9,929,662	10,597,633	67,475	158,318	9,539,947	10,028,028
220 Multipurpose parts, Kg.	3,741	19,229	236,609	261,044	1,640	9,383	391,080	405,669
Total	200,376	1,232,106	18,082,905	21,076,412	121,165	1,150,409	15,647,866	19,627,589
85.15-								
424 VHF transmitters and transmitter-receivers, No.	2,832	8,976	638,237	798,063	3,176	7,412	763,544	924,650
425 Other transmitters and transmitter-receivers, No.	39,810	43,037	1,437,647	1,493,266	74,413	85,147	1,842,911	1,976,192
510 Parts of radiotelegraphic-radiotelephonic, radio broadcasting and television transmission and reception gear; and television cameras, Kg.	45,413	1,656,262	1,788,226	11,412,713	133,176	1,501,957	1,467,021	6,812,627
Total	88,055	1,708,275	3,864,110	13,704,042	210,765	1,594,516	4,073,476	9,713,469
85.21-								
140 Tubes for telephonic-telegraphic, radio broadcasting and television transmission gear (excluding receiving tubes), No.	8,779	10,328	562,799	599,630	5,222	28,188	212,853	588,297
85.23-								
120 Communications cable, Kg.	10,761	26,760	139,664	185,412	4,945	65,035	89,092	140,140
90.13-								
091 Other optical appliances and instruments, No.	16,912	1,138,350	4,666,424	5,861,346	22,802	425,733	2,924,186	4,223,534
099 Parts and accessories for optical appliances, instruments and lasers, Kg.	37,117	41,380	1,970,672	2,084,825	23,004	34,430	1,289,240	1,457,462
Total	54,029	1,179,730	6,637,096	7,946,171	45,806	460,163	4,213,426	5,680,996
90.25-								
030 Instruments and gear for checking quantities of heat, light or sound and parts, Kg.	391	1,234	21,148	84,891	259	705	20,453	28,770
90.28-								
121 Spectrum analyzers	463	470	2,130,964	2,151,859	442	480	1,780,223	1,844,902
Total	362,854	4,158,903	31,438,686	45,748,417	388,604	3,299,496	26,037,389	37,624,163

Source: Ministry of Finance, Japan Tariff Association

Table 3: U.S. Exports of Selected Communications Equipment, 1982-1985

(in indicated quantity units and $1,000)

Trade classification number, item and units		1982				1983			
		Quantity		Value		Quantity		Value	
		Japan	Total	Japan	Total	Japan	Total	Japan	Total
75260-									
90	Computer communications and peripheral equipment, No.	18,461	356,090	$51,044	$563,917	20,170	415,562	$51,370	$596,162
76440-									
10	Telephone switching and switchboard equipment and parts	--	--	1,103	378,904	--	--	4,474	439,907
20	Telephone instruments, No.	9,209	305,647	1,209	24,259	10,667	334,084	835	27,714
30	Other telephonic gear and parts	--	--	4,869	274,678	--	--	9,372	203,258
40	Teleprinting and teletypewriting machines, No.	624	23,701	1,577	37,378	649	15,606	1,016	28,165
50	Telegraph gear and parts, No.	--	--	747	113,926	--	--	1,395	90,917
	Total	9,833	329,348	9,505	829,145	11,316	349,690	17,092	789,961
76493-									
40	Satellite communications antennas, No.	4	3,229	326	11,157	57	14,260	211	28,782
50	Radio telegraphic-telephonic transmission and reception equipment and parts	--	--	19,544	523,017	--	--	21,514	681,581
	Total	4	3,229	19,870	534,174	57	14,260	24,725	710,363
77310-									
05	Telephone and telegraph cable (except fiber-optic), Lb.	57,049	29,742,515	330	51,185	33,758	22,997,637	236	55,471
10	Communications wire and cable (except fiber-optic), Lb.	321,200	15,506,125	1,156	42,608	140,487	24,652,032	958	52,005
	Total	378,249	45,248,640	1,486	93,793	174,245	47,649,669	1,194	218,037
87528-									
70	Electric, radio and communications circuit testing equipment	--	--	46,332	223,748	--	--	44,067	218,037
88411-									
10*	Fiber-optic strands and cable, Lb.	57	57	3	3	280	280	6	6
Total		406,604	45,937,364	128,240	2,244,780	206,068	48,429,461	135,454	2,242,005

Table 3 (continued)

(in indicated quantity units and $1,000)

Trade classification number, item and units	1982				1983			
	Quantity		Value		Quantity		Value	
	Japan	Total	Japan	Total	Japan	Total	Japan	Total
75260-								
90 Computer communications and peripheral equipment, No.	32,662	808,892	$75,914	$814,022	38,229	851,879	$92,983	$899,141
76440-								
10 Telephone switching and switchboard equipment and parts	--	--	7,764	399,234	--	--	15,132	362,673
20 Telephone instruments, No.	79,256	645,051	3,396	36,996	94,238	717,978	4,363	37,322
30 Other telephonic gear and parts	--	--	27	20,154	--	--	19,394	313,825
40 Teleprinting and teletypewriting machines, No.	1,221	45,302	3,169	87,223	403	13,044	559	16,693
50 Telegraph gear and parts, No.	--	--	3,024	110,655	--	--	2,576	101,591
Total	80,477	690,353	17,380	654,262	94,641	731,022	42,024	832,104
76493-								
40 Satellite communications antennas, No.	648	16,782	8,359	70,096	184	100,967	1,842	26,701
50 Radio telegraphic-telephonic transmission and reception equipment and parts	--	--	16,670	755,769	--	--	22,905	815,709
Total	648	16,782	25,029	825,865	184	100,967	24,747	842,410
77310-								
05 Telephone and telegraph cable (except fiber-optic), Lb.	62,737	16,221,511	327	32,523	23,859	10,382,355	1,074	20,065
10 Communications wire and cable (except fiber-optic), Lb.	266,248	26,197,181	1,786	63,995	225,989	16,597,234	3,890	63,021
Total	328,985	42,418,692	2,113	96,518	249,848	26,979,589	4,964	83,086
87528-								
70 Electric, radio and communications circuit testing equipment	--	--	24,141	193,069	--	--	27,191	218,268
88411-								
10* Fiber-optic strands and cable, Lb.	361	361	42	42	1,459	19,707	96	394
Total	443,133	13,935,080	144,619	2,583,778	384,361	28,683,164	192,005	2,875,403

*Includes other countries.

Source: U.S. Department of Commerce

Table 4: U.S. Exports of Selected Communications Equipment, January-July, 1983-1986

(in indicated quantity units and $1,000)

	1983				1984			
	Quantity		Value		Quantity		Value	
Trade classification number, item and units	Japan	Total	Japan	Total	Japan	Total	Japan	Total
75260-								
90 Computer communications and peripheral equipment, No.	194	8,638	$505	$7,787	19,339	493,250	$35,159	$439,765
76440-								
10 Telephone switching and switchboard equipment and parts	--	--	611	8,218	--	--	4,487	258,836
20 Telephone instruments, No.	4,149	33,572	210	2,424	5,153	351,236	715	21,698
30 Other telephonic gear and parts	--	--	52	6,749	--	--	7,909	116,731
40 Teleprinting and teletypewriting machines, No.	9	526	60	1,722	465	8,503	738	16,950
50 Telegraph gear and parts	--	--	71	2,886	--	--	1,863	67,809
Total	4,158	34,098	1,004	21,999	5,618	359,739	15,712	482,024
76493-								
40 Satellite communications antennas, No.	32*	132*	27*	136*	14	9,712	151	15,680
50 Radio telegraphic-telephonic transmission and reception equipment and parts	--	--	1,012	5,811	--	--	10,874	447,752
Total	32	132	1,039	5,947	14	9,712	11,025	463,432
77310-								
05 Telephone and telegraph cable (except fiberoptic), Lb.	510*	36,509	11*	100	38,773	10,429,732	221	20,921
10 Communications wire and cable (except fiberoptic), Lb.	1,154	94,878	44	217	117,157	15,369,808	836	34,684
Total	1,664	131,387	55	317	155,930	25,799,540	1057	55,605
87528-								
70 Electric, radio and communications circuit testing equipment	--	--	46	3,409	--		15,669	106,425
88411-								
10 Fiberoptic strands and cable, Lb.	--	--	--	--	3,372	547,116	304	17,999
Total	4,544	44,525	2,649	19,659	184,273	27,209,357	78,926	1,565,250

Table 4 (continued)

(in indicated quantity units and $1,000)

Trade classification number, item and units	1985				1986			
	Quantity		Value		Quantity		Value	
	Japan	Total	Japan	Total	Japan	Total	Japan	Total
75260-								
90 Computer communications and peripheral equipment, No.	20,433	547,332	$53,432	$520,722	22,816	439,815	$42,169	$499,464
76440-								
10 Telephone switching and switchboard equipment and parts	--	--	10,034	229,563	--	--	9,474	211,796
20 Telephone instruments, No.	87,465	348,763	3,535	19,306	10,470	395,751	1,257	22,663
30 Other telephonic gear and parts	--	--	11,748	162,806	--	--	16,253	172,812
40 Teleprinting and teletypewriting machines, No.	305	9,009	378	11,186	152	5,985	504	9,613
50** Telegraph gear and parts, No.	--	--	1,817	60,442	--	--	--	--
60 Modems, No.	--	--	--	--	162	10,200	354	11,098
70** Telegraph gear and parts, No.	--	--	--	--	--	--	452	67,678
Total	87,770	357,772	27,512	483,303	10,784	411,936	28,294	495,660
76493-								
40 Satellite communications antennas, No.	102	93,970	793	12,866	28	13,494	822	13,710
50 Radio telegraphic-telephonic transmission and reception equipment and parts	--	--	4,819	320,996	--	--	15,147	566,129
Total	102	93,970	5,612	333,862	28	13,494	15,969	579,839
77310-								
05* Telephone and telegraph cable (except fiber-optic), Lb.	19,887	6,179,859	1,041	12,753	--	--	--	--
10 Communications wire and cable, (except fiber-optic), Lb.	151,293	10,994,833	1,781	36,281	107,324	8,967,056	3,170	46,619
Total	171,180	17,174,692	2,822	49,034	107,324	8,967,056	3,170	46,619
87528-								
70 Electric, radio and communications circuit testing equipment	--	--	18,971	142,463	--	--	15,743	115,684
88411-								
10* Fiber-optic strands and cable, Lb.	5,346	137,935	2,502	16,948	72,673	1,282,141	527	13,527
Total	284,831	18,311,701	110,851	1,546,332	213,625	11,114,442	105,872	1,750,793

*Exports of this category to Japan were grouped with several other countries.
**76440-50 became 76440-70 in 1986.

Source: U.S. Department of Commerce

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JEI

REPORT

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Exchange Rates And The Japanese Economy

The yen-dollar exchange rate continues to fluctuate in a narrow range between Y160 and Y164=$1.00 following the October 31 currency agreement between Japan and the United States (see JEI Report No. 41B, November 7, 1986). Bank of Japan governor Satoshi Sumita recently praised the accord as a stabilizing force reducing uncertainty over currency values. The recent stability has been achieved, he said, without exchange market intervention by Japan's central bank.

In contrast to the yen, the West German mark has continued to appreciate against the dollar, and hence against the yen as well. The yen's 10 percent drop against the mark since July is a result of several factors, including the addition, a committee has been set up to provide firms with information about the Japanese market. Without these actions, Seoul estimates, its deficit with Japan will reach $7.7 billion in 1991.

This is one of the few problems troubling the Korean economy, which is benefiting from low oil prices, the weak won and low interest rates. The government projects that real economic growth, which is expected to reach 12 percent this year, will continue strong at 8 percent in 1987, raising gross national product above $100 billion for the first time. It also forecasts that a 13 percent rise in exports will raise Korea's current account surplus to $5 billion in 1987, allowing it to reduce its $45 billion foreign debt.

Randall S. Jones

Polls Prove Positive In U.S.-Japan Relations

Despite continued economic disputes, surveys published recently in Japan's two largest daily newspapers indicate that support for the overall U.S.-Japan relationship is high, particularly in the United States. The *Asahi Shimbun* and *Yomiuri Shimbun* devoted several pages of their issues last week to comprehensive polls conducted by leading polling organizations in the United States and concluded that the bilateral relationship remains in sound health overall.

Perhaps the most surprising aspect of the reports is that American respondents consistently gave higher marks to the health of the relationship than their Japanese counterparts. While 59.7 percent of U.S. respondents characterized bilateral relations as good or very good in the *Yomiuri* poll, only 42.1 percent of the Japanese offered similar assessments. (This may be because Japanese respondents traditionally are more reluctant to express clear-cut views). Only 3.4 percent of those queried in the United States felt that relations with Japan were bad, while 16.8 percent in Japan felt that relations with this country were worsening. While favorable attitudes toward the relationship have been the rule in the United States -- with attitudes consistently recording good or very good by overwhelming margins in the last three years -- the Japanese seem to be taking a darker view. The percentage responding negatively in the most recent survey was more than twice the level of two years ago, while the good/very good category has fallen from 53 percent in 1984 to the current 42.1 percent level.

Despite these figures, the standing of the United States appears very high. The United States is at the top of the list of 30 countries for trustworthiness, with a 52.7 percent favorable rating. This was lower than the 1985 poll but still higher than the 49.6 percent of four years ago. American respondents ranked Japan only seventh in this category out of 30 nations, but higher than the previous year's results.

Perceptions of trade issues on both sides of the Pacific were mixed. Slightly under half of the Americans in the *Yomiuri* survey indicated that Japan has not been making sufficient efforts to liberalize its markets, a perception shared by just over 30 percent of the Japanese respondents. (Almost the same proportion said that Japan is cooperating to a "certain degree" with other

Yomiuri Shimbun Survey
December 1986

Current State of U.S.-Japan Relations

	U.S. Respondents			Japanese Respondents		
	1986	1985	1984	1986	1985	1984
Very good	14.4%	13.8%	14.8%	3.3%	2.4%	5.3%
Good	45.3	46.4	44.0	38.8	38.4	47.7
Neither good nor bad	32.0	30.1	31.7	32.1	35.0	31.5
Bad	3.4	4.0	3.2	16.8	16.9	8.1
No opinion	4.8	5.7	6.3	9.0	7.2	7.5

Outlook for Future U.S.-Japan Economic Relations

	U.S. Respondents		Japanese Respondents	
	1986	1985	1986	1984
Much better	10.8%	8.0%	1.7%	1.3%
Somewhat better	37.5	37.9	16.4	25.9
No change	28.6	24.3	46.3	42.0
Slightly worse	13.1	15.5	21.3	18.5
Much worse	1.5	2.4	2.6	2.1
Don't know	8.5	11.9	11.6	10.1

Asahi Shimbun Survey
December 1986

Present State of U.S.-Japan Relations

	U.S. Respondents	Japanese Respondents
Smooth relations	64%	48%
Poor relations	33	30
Neither	--	14
No answer	3	8

Outlook for Future Relations

	U.S. Respondents	Japanese Respondents
Favorable direction	32%	14%
Turn for worse	16	15
No change	45	56
No answer	7	15

countries to liberalize its markets.) Americans in the Asahi poll, however, had mixed feelings over the degree of openness in Japan. Respondents divided almost equally in that survey, blaming both a closed market and lack of competitiveness in the United States as the principal reasons for what they perceived as relatively low sales in Japan. (The vast majority, however, were not aware that Japan is the United States' largest market for agricultural exports.)

Analysts in the respective dailies concluded that despite the somewhat conflicting implications of the surveys, the numbers demonstrated that relations between the United States and Japan are sound and likely to remain so in the future. This is a particularly significant finding in light of the prospects for protectionist legislation in the next Congress.

Michael W. Chinworth

USTR Issues Annual Trade Barriers Report

The Office of the U.S. Trade Representative issued its second annual report on foreign trade barriers November 17. The report, required under Section 303 of the Trade and Tariff Act of 1984, lists "significant" barriers that affect U.S. exports of goods and services, American investment abroad and intellectual property rights. While the study does not claim to be comprehensive, its purpose is to identify those barriers that are most important to the United States -- whether or not they are consistent with international trade agreements.

The study outlines 12 categories of trade barriers: tariffs and other import charges; quantitative restrictions; import licensing; customs barriers; standards, labeling and certification procedures; government procurement; export subsidies; lack of intellectual property protection; countertrade and offsets; services barriers; investment barriers; and other barriers. Some 40 nations are examined in the report, up from 34 in the 1985 study. Additions include the People's Republic of China, Greece, Ireland, Kenya, Nigeria and Yugoslavia -- as well as one regional trading organization, the Middle East's Gulf Cooperation Council. The trade barriers of most nonmarket economies are excluded from the report, as are those of the United States.

Since the report is based largely on information gathered over time by the USTR, other government agencies, embassies and the private sector, those countries whose barriers have long been a focus of concern have been the subject of intensive research. The quantitative list of grievances, therefore, may not reflect the actual distribution of foreign trade barriers.

Listed last year as having 30 barriers, Japan's 1986 count is still 30:

- Tariffs and other import charges - Cigarettes and tobacco products; wood and paper products; alcoholic beverages and wine; aluminum; fresh grapefruit; walnuts; candy and chocolate confectionery.

- Quantitative restrictions - Fish products; agricultural products; leather and leather footwear.

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REPORT

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ECONOMIC GROWTH AND INDUSTRIAL RESTRUCTURING IN JAPAN

Summary

In the fall of 1985 Prime Minister Yasuhiro Nakasone established a panel of advisers to recommend changes in Japan's economy that would reduce its large trade surplus and lessen friction with other countries. The commission, chaired by former Bank of Japan governor Haruo Maekawa, submitted a report last April calling for an industrial restructuring. It advocated shorter working hours and higher wages, financial liberalization, improved market access for imports, more housing construction, an end to the tax exemption on interest from small savings accounts, and a rapid increase in foreign direct investment. A second committee, also chaired by Mr. Maekawa, is working on specific proposals.

Economic restructuring carries the threat of a rise in unemployment, which has become a major issue in Japan since the yen's appreciation. With industrial production and export volume falling, a Ministry of International Trade and Industry report issued in November called the employment situation in the manufacturing sector the most serious in the postwar era. Economic Planning Agency analysts calculate that 4 percent real economic growth is a prerequisite for the restructuring of Japan's economy. Since the 1973 oil shock, this has been the average rate, but it will be difficult for Japan to achieve 4 percent real growth during the next five years while reducing both the trade surplus and the government budget deficit.

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Concern Over Rising Unemployment

Japan has successfully avoided many of the economic problems that have plagued other industrialized countries since the first oil shock. From 1974 to 1985, Japan's unemployment rate averaged 2.2 percent, compared to 5.1 percent in West Germany and 7.5 percent in the United States (see Table 1). At the same time, its inflation rate was below the average for the major industrialized countries.

Table 1: Unemployment and Inflation in Industrialized Countries, 1975-85

(average annual rate)

	Unemployment Rate	Consumer Price Increase
United States	7.5%	7.4%
Japan	2.2	5.3
West Germany	5.1	4.2
France	6.7	10.2
United Kingdom	8.5	12.0
Italy	8.1	15.3
Canada	8.8	8.4
Weighted Average	6.3	7.7

Source: Organization for Economic Cooperation and Development

Part of the explanation for Japan's comparatively low jobless rate is statistical. U.S. figures include all those who are out of work for a month; Japan limits its definition to those receiving unemployment insurance. In addition, Tokyo excludes laid-off workers because they continue to receive part of their wages. In Japan, moreover, military personnel and those working more than one hour a week are counted as employed, while armed forces personnel and those working less than 15 hours a week are not considered part of the labor force in this country. If Japan's unemployment rate were calculated using the U.S. definition, the Ministry of International Trade and Industry estimates that it would be over 5 percent rather than the 2.8 percent reported in October. Still, it compares favorably with the U.S. rate, which stood at 7 percent in November.

Many politicians and business leaders, though, are alarmed at the situation. The manufacturing sector in October employed 230,000 fewer people than a year ago, with job losses concentrated in smaller firms. Those with under 30 workers employed 80,000 fewer employees, while medium-sized companies (30 to 499 workers) cut back 60,000.

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Moreover, many economists expect Japan's unemployment rate to rise in the future. A study by the Sanwa Research Institute estimates that 900,000 of the 14.4 million people employed in the manufacturing sector are surplus workers. Another report predicts that the increase in foreign direct investment between FY 1983 and FY 2000 will cost Japan 600,000 jobs. Not surprisingly, the Japan Economic Research Center forecasts a 4.2 percent unemployment rate in FY 1991. In response, the government has established an office to cope with the problem. Meanwhile, Eishiro Saito, chairman of Keidanren, has called on the government to include effective measures against unemployment in its FY 1987 budget.

As the industrial restructuring continues, other sectors of Japan's economy must expand to replace jobs lost in manufacturing and prevent a serious rise in unemployment. Last month, Tetsuo Kondo, director general of the Economic Planning Agency, warned that "industrial and economic structural adjustments are possible only if we can achieve real growth of about 4 percent." Although that rate is in line with the 4.2 percent average from 1974 to 1985, it will be a difficult pace to maintain for two reasons. First, the reduction of Japan's trade surplus, which is estimated at $85 billion in 1986, will exert a significant drag on the economy. Second, the commitment to end the issue of deficit-financing bonds by FY 1990 limits the government's ability to adjust fiscal policy to boost the economy.

Table 2: Japan's Real Gross National Product, 1980 and 1985

(in billions of yen at constant 1980 prices)

	FY 1980	FY 1985	Average Annual Growth
Gross National Product	Y242,130.9	Y293,332.7	3.8%
Personal Consumption Spending	141,397.8	162,999.0	2.8
Private Residential Construction	15,114.2	14,107.9	-1.4
Private Fixed Nonresidential Investment	38,293.4	53,760.3	6.8
Change in Business Inventories	2,096.9	2,016.2	-0.8
Government Current Expenditures	23,755.6	27,240.9	2.7
Government Fixed Investment	23,153.9	20,772.5	-2.2
Change in Government Inventories	-274.3	297.9	*
Net External Sector	-1,406.6	12,138.1	*
Exports of Goods and Services and Factor Income Received	36,688.9	54,496.6	7.9
Imports of Goods and Services and Factor Income Paid	38,095.5	42,358.6	2.1

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

Net exports have provided a major boost to Japan's economy, accounting for over one-fourth of the 21 percent rise in real GNP between FY 1980 and FY 1985 (see Table 2). The contraction of the trade surplus in coming years will have an equally powerful negative effect. Japan has already had a taste of this effect as net exports have now declined for five consecutive quarters. Assuming net exports return to balance, 4 percent real annual growth implies that domestic demand will have to increase Y91,704.3 billion ($573 billion at Y160=$1.00) by 1991. If government spending continues to grow at its FY 1980 to FY 1985 real yearly pace of 0.7 percent, private domestic demand will have to increase at an inflation-adjusted 5.4 percent annual rate -- a sharp step-up from the 3.4 percent a year rate during the first half of the 1980s.

Growth at that level, of course, would not be unprecedented in Japanese economic history. Between 1965 and 1973, private domestic demand rose at an inflation-adjusted 9.7 percent annual rate, exceeding the 9.0 percent growth of GNP. But is real growth in private investment and consumption of over 5 percent feasible in the stable growth era? The answer depends, in part, on whether the end of high growth in 1973 was the result of a change in government policies or of underlying economic trends.

A New High Growth Era?

Edward Denison and William Chung's chapter in Asia's New Giant identifies the increase in Japan's capital stock resulting from its high investment rate as the key factor explaining the robust growth of the 1960s and early 1970s. Private investment in plant and equipment, however, which had grown 14.0 percent annually in real terms from 1965 to 1973, fell to a 4.1 percent a year rate during the following 12 years. As a share of GNP, it dropped from 17.7 percent in 1973 to 14.3 percent in 1978. The sharp decline in investment growth following the first oil shock, therefore, is one explanation of the slowdown.

One possible reason for the scaled-back expansion of capital spending was a shift in priorities in the early 1970s. Tokyo made a conscious decision to improve the quality of life through increased expenditures on social infrastructure and pollution control. This decision produced more roads, better sewage facilities and an improvement in environmental quality. Moreover, greater resources were channeled into housing. As a result of the increase in government spending, the budget swung from a surplus equivalent to 1.8 percent of GNP in 1970 to a deficit equal to 5.5 percent in 1978.

Rising budget deficits during the 1970s crowded out private investment in many countries, slowing economic growth. This does not appear to have been the case in Japan, given the country's high saving rate. Even at the deficit's peak in 1978, domestic savings exceeded private investment and the budget deficit by an amount equivalent to 1.7 percent of GNP. Government red ink merely stepped in to fill the gap resulting from the investment decline. Moreover, it can be argued, the resulting improvement in living standards added to economic growth.

Edward Lincoln of The Brookings Institution emphasizes the importance of the technological gap between Japan and other countries in encouraging investment during the high growth period. Japan's ability to absorb and adapt foreign technology made large jumps in productivity possible, raising the expected profits from investment in new plant and equipment. But as the country advanced, the technological gap narrowed and had largely disappeared by the mid-1970s, according to some estimates. This forced Japanese firms to undertake their own research and development, a more costly approach that lowered the return on investment. Dr. Lincoln also points out that the benefits of economies of scale were largely exhausted by the mid-1970s.

The slowdown in growth is also a result of changes in labor inputs. The expansion of the labor force slowed from a 1.3 percent annual rate in the 1960-73 period to only 0.9 percent a year from 1973 through 1985 (see Table 3). The decline reflects the slower rate of population increase as well as a small drop in the labor force participation rate. More importantly, the shift of labor from low productivity activities in agriculture to higher productivity jobs in manufacturing and services was largely completed by 1973. In 1965 workers in the primary sector accounted for 23.5 percent of total employment but produced only 11 percent of gross domestic product (see Table 4). The productivity of manufacturing workers, who accounted for about the same share of the labor force but produced over one-fourth of gross domestic product, was more than double that of workers in the primary sector. Service sector employees were also substantially more productive than those in agriculture, forestry and fishing.

Table 3: Labor Force Statistics

Year	Labor Force (in millions)	Labor Force Participation Rate	Unemployment Rate	Monthly Hours Worked
1960	45.1	69.2%	1.7%	202.7
1965	47.9	65.7	1.2	192.9
1970	51.5	65.4	1.1	186.6
1973	53.3	64.7	1.3	182.0
1975	53.2	63.0	1.9	172.0
1980	56.5	63.3	2.0	175.7
1985	59.6	63.0	2.6	175.8

Source: Management and Coordination Agency, Japan Statistical Yearbook

By 1973 the share of total employment in the primary sector had dropped 10 percentage points, a shift of more than half a million workers a year on average, although of course some retired rather than take jobs in manufacturing or services. The transfer provided a major boost to economic growth. From 1973 to 1985, though, the primary sector's share of workers fell at a slower rate; the 4.6 percentage points drop represents a shift of only 160,000 a year on average.

Table 4: Employment by Sector*

(percentage distribution)

Year	Primary	Secondary	Tertiary	Total Employment (in millions)
1965	23.5%	31.9%	44.6%	47.3
1970	17.4	35.2	47.3	50.9
1973	13.4	36.6	49.8	52.6
1975	12.7	35.2	51.9	52.2
1980	10.4	34.8	54.6	55.4
1985	8.8	34.3	56.9	58.1

*The primary sector includes workers in agriculture, forestry and fisheries, while the secondary sector covers manufacturing, mining and construction. The tertiary sector includes workers in the service sector, government and utilities.

Source: Management and Coordination Agency, Japan Statistical Yearbook

The economy's slower pace is also a reflection of smaller gains in the volume of exports. Although net exports have made a significant contribution to GNP in some years, the 8.1 percent annual expansion in export volume since 1973 is well below the 12.3 percent rate recorded from 1965 to 1973 (see Table 5). One reason has been the slowdown in the growth of Japan's trading partners. During the earlier period, world economic growth averaged an inflation-adjusted 4.8 percent annual rate. Since 1973, however, that rate has fallen to 2.7 percent. Second, as Japan's share of world exports doubled from 5 percent in 1965 to 10 percent last year, political factors have constrained overseas shipments, including both protectionist barriers and "voluntary" self-restraint on Tokyo's part.

Table 5: Export and Import Volume

(1980=100)

Year	Export Volume	Import Volume	Trade Balance (billions of dollars)
1960	7.7	16.1	$0.3
1965	20.0	27.6	1.9
1970	39.8	61.5	4.0
1973	53.6	91.1	3.7
1975	64.4	79.4	5.0
1980	100.0	100.0	2.1
1985	142.3	109.5	56.0

Source: Japan Tariff Association

The sudden increase in oil prices in 1973 obviously had a negative effect on the economy. In addition to the transfer of income to oil exporters, Japan faced high adjustment costs. But while the oil shock provided a traumatic finale to the high growth era, it was not the major cause of its end. Japan's high rate of growth prior to 1973 was the result of temporary factors that were largely played out by the early 1970s.

Japan's Growth Potential

The determinants of economic growth are gains in labor productivity and changes in the growth of the labor force, total hours worked and the unemployment rate. An estimate of Japan's growth potential depends on assumptions about each of these four variables.

The government estimates that the working age population (15 to 64 years old) will increase at a 0.9 percent annual rate through 1990. The actual growth in the labor force depends on participation rates, which have remained practically constant during the past 15 years. The rate for women has been virtually unchanged since 1970, disguising a sharp increase in the 20-to-54 age bracket that has been offset by a decline in teenagers and the elderly (see Table 6). The female participation rate is likely to increase in coming years as more women choose either to remain in the labor force or return to it after marriage and children. This increase, though, is likely to be offset by a continuation of the sharp drop in participation by elderly men.

Table 6: Labor Force Participation Rates

(by age category)

Male

Year	15-19	20-24	25-34	35-44	45-54	55-64	65 and Over	Total
1970	31.4%	80.7%	97.4%	97.7%	96.5%	86.6%	49.4%	81.8%
1975	20.5	76.5	97.6	97.8	96.5	86.0	44.4	81.4
1980	17.4	69.6	97.0	97.6	96.3	85.4	41.0	79.8
1984	18.2	71.0	96.8	97.7	96.4	83.8	37.6	78.8

Female

Year	15-19	20-24	25-34	35-44	45-54	55-64	65 and Over	Total
1970	33.6%	70.6%	46.8%	60.1%	60.1%	44.4%	17.9%	49.9%
1975	21.7	66.2	43.2	56.9	59.8	43.7	15.3	45.7
1980	18.5	70.0	48.7	60.9	62.0	45.3	15.5	47.6
1984	18.5	72.4	52.1	63.7	64.1	45.0	15.9	48.9

Source: Management and Coordination Agency, Japan Statistical Yearbook

One of the reforms proposed by the Maekawa Commission is a reduction in the number of hours worked, which are high by international standards. Annual working hours per employee in 1985, for example, were about 1,947 in Japan compared to 1,742 in the United States and 1,535 in West Germany. Despite the government's efforts to promote the five-day work week, working hours have remained virtually unchanged since 1974 and there is unlikely to be any major decline in the near future.

Labor productivity is influenced by a variety of factors, including the level of the capital stock and the rate of technological innovation. Numerous methods are used to measure productivity, resulting in a variety of conflicting indices. The Japan Productivity Center reports that labor productivity in manufacturing has risen at an average rate of almost 4.3 percent since 1980. In contrast, Nomura Research Institute estimates that productivity gains in manufacturing averaged 3.2 percent from 1979 to 1984. Still, Japanese productivity is high compared to other countries according to either estimate. Former Council of Economic Advisers chairman Alan Greenspan estimates that "from 1981 through our projection for 1986, output per man-hour in the nonfarm business sector grew at an average annual rate of less than 1.2 percent" in the United States.

Based on optimistic assumptions that the labor force will grow at 0.9 percent a year and working hours will remain unchanged, productivity will have to increase at a 4.5 percent annual rate if domestic output is to expand by 5.4 percent a year -- the pace needed to meet the government's growth outlook while still reducing both the trade surplus and budget deficit. This outcome is certainly feasible -- the Japanese economy has demonstrated the ability to adapt to changing conditions in the past. But should productivity increase at the 3.2 percent rate calculated by Nomura, for example, growth will fall short of expectations. Moreover, it should be remembered that these projections are based on the results of the manufacturing sector, where productivity gains generally exceed those in services and agriculture.

Conclusion

Tokyo has identified three economic goals for the second half of the 1980s:

- Real economic growth of 4 percent, a rate considered necessary to permit a restructuring of the Japanese economy.

- A reduction in Japan's trade surplus, a source of growing international friction.

- An end to government reliance on deficit-covering bonds by FY 1990.

For the reasons outlined in the previous section, however, it will be difficult for the government to achieve all these objectives simultaneously during the next five years.

Regardless of official government plans, the high yen has already set in motion a restructuring of Japan's economy that is reducing industrial production and employment. One alternative is for the government to adopt a lower growth target at the expense of a rise in unemployment. But it is likely that Tokyo's major priority will be to maintain economic growth through this period of adjustment and prevent a serious rise in unemployment. The goal of reducing Japan's record trade surpluses also cannot be easily abandoned. Although it cannot be completely eliminated by 1991, a significant reduction would reduce tension with trading partners and prevent protectionist measures.

The emphasis placed on reducing the government budget deficit reflects concern over the rising costs of servicing the public debt. Net interest payments will absorb over 20 percent of Japan's central government expenditures in 1986 compared to about 14 percent in this country. The central government debt to GNP ratio in 1985 was 52.1 percent in Japan versus 48.4 percent in the United States. Despite these concerns, however, it is likely that the first two goals will take priority should all three prove unattainable. Last week the influential business group Keidanren urged the government to boost public works spending by temporarily shelving its goal of eliminating the budget deficit.

For further information, contact Randall Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI Report will not be published on December 26 or January 2 because of the Christmas and New Year's holidays. The next issue will appear January 9, 1987.

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JEI

REPORT

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Japan's Economy Slows In Third Quarter

A decline in net exports slowed inflation-adjusted growth in Japan's gross national product to a 2.6 percent annual rate in the July-September quarter, down from a revised 3.8 percent in the April-June period. The sluggish growth rate makes it unlikely that the economy will reach the government's outlook of 4 percent real growth in FY 1986 (April 1, 1986 to March 31, 1987).

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Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1985	October-December 1985	January-March 1986	April-June 1986	July-September 1986
Gross National Product	Y293,332.7 (4.3%)	Y295,760.3 (4.7%)	Y294,483.4 (-1.7%)	Y297,230.1 (3.8%)	Y299,128.5 (2.6%)
Personal Consumption Spending	162,999.0 (2.6%)	163,477.4 (2.1%)	164,123.7 (1.6%)	166,134.2 (5.0%)	168,252.2 (5.2%)
Private Residential Construction	14,107.9 (2.9%)	14,124.4 (6.8%)	14,340.6 (6.3%)	14,808.5 (13.7%)	15,857.2 (31.5%)
Private Fixed Nonresidential Investment	53,760.3 (12.9%)	54,811.3 (10.8%)	54,983.4 (1.3%)	55,204.3 (1.6%)	55,469.9 (1.9%)
Change in Business Inventories	2,016.2 (8.7%)	2,172.1 (77.0%)	1,726.5 (-60.0%)	639.5 (-98.1%)	809.4 (156.6%)
Government Current Expenditures	27,240.9 (1.9%)	27,370.1 (3.9%)	27,606.7 (3.5%)	27,719.2 (1.6%)	28,015.3 (4.3%)
Government Fixed Investment	20,772.5 (-6.4%)	20,960.5 (7.1%)	21,022.4 (1.2%)	21,785.4 (15.3%)	22,144.6 (6.8%)
Change in Government Inventories	297.9 (*)	608.7 (*)	39.6 (*)	3,251.8 (*)	1,795.1 (*)
Net External Sector	12,138.1 (19.9%)	12,235.9 (-4.7%)	10,640.6 (-42.8%)	7,687.2 (-72.8%)	6,784.8 (-39.3%)
Exports of Goods and Services and Factor Income Received	54,496.6 (1.8%)	53,973.3 (-7.1%)	52,208.9 (-12.4%)	53,044.1 (6.6%)	52,497.7 (-4.1%)
Imports of Goods and Services and Factor Income Paid	42,358.6 (-2.4%)	41,737.5 (-7.8%)	41,568.3 (-1.6%)	45,356.9 (41.8%)	45,712.9 (3.2%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

Domestic demand accounted for 0.9 percentage point of the 0.6 percent quarterly GNP gain, while the external sector lowered growth by 0.3 percentage point. Net exports have now declined for five consecutive quarters, reflecting the impact of the strong yen. Economic Planning Agency officials note that the economy is apparently shifting from exports to domestic demand.

Housing construction soared at a 31.5 percent real annual rate, the highest in 10 years (see Table), as a result of lower interest rates and a cut in taxes on housing. The front-loading of public works projects in the first half of FY 1986 resulted in a substantial rise in government capital formation. Business fixed investment, however, remained sluggish for the third consecutive quarter, reflecting the drop in earnings. Wako Research Institute of Economics estimates that the pretax profits of Japan's major firms will drop 19.9 percent in the current fiscal year.

Encouraged by the stability of prices, the inflation-adjusted rise in consumer spending was in the 5 percent range for the second straight quarter. Many economists, though, question whether it will continue to expand at this rate. While the deflationary effects of the strong yen have been concentrated in export-oriented industries, a report last week by the Bank of Japan said there are signs that it is spreading to the rest of the economy through wage and employment adjustments. One indication is smaller yearend bonuses for workers. A survey by Nikkeiren (Japan Federation of Employers' Associations) estimates that December 1986 bonuses will be 2.8 percent below last year's.

A study of wholesale and consumer prices by the Bank of Japan concluded that business firms have not passed on to consumers enough of the benefits of the yen's appreciation. Import prices in Japan plunged 43 percent between September 1985 and September 1986, compared to 21.5 percent in West Germany. But while consumer prices fell 0.9 percent in West Germany in that period, they rose 0.5 percent in Japan. A report to the Minister of Labor reached the same conclusion; a survey of more than 100 consumer items concluded that it takes Y231 (about $1.44 at Y160=$1.00) to buy the same products in Japan that $1.00 buys in the United States.

With the Bank of Japan's discount rate at a postwar low of 3 percent, efforts to boost the economy will probably rest with fiscal policy. The Ministry of Finance plans to present the draft FY 1987 budget on December 25, a draft that will take into account tax reform proposals. MOF officials indicated last week that the budget may not achieve the government's goal of reducing deficit-covering bonds by Y1.31 trillion ($8.2 billion) in the year starting April 1, 1987.

Randall S. Jones

Ups And Downs In Cabinet Support

According to a recent survey by the Asahi Shimbun, support for the cabinet of Yasuhiro Nakasone has fallen to its lowest level in three years. The December 7 edition reported a drop to 39 percent, far from the 53 percent figure of May 1986. More significantly, outright opposition to the cabinet had increased to 33 percent, well over 10 percentage points above figures compiled last spring.

Cabinet Support, December 1982-December 1986

(percentage)

Date	Favor Cabinet Policies	Disapprove	No Opinion
December 1982	37%	37%	26%
February 1983	29	43	28
May 1983	30	40	30
August 1983	35	43	22
October 1983	34	39	27
December 1983	34	41	25
March 1984	45	33	22
May 1984	44	32	25
September 1984	40	32	28
October 1984	45	30	25
December 1984	42	30	28
March 1985	45	30	25
May 1985	47	26	27
June 1985	45	25	30
October 1985	46	29	25
December 1985	43	27	30
March 1986	53	21	26
May 1986	53	22	25
August 1986	48	30	22
October 1986	42	32	26
December 1986	39	33	28

Source: Asahi Shimbun

Although the possible reasons for the decline are not entirely clear, the newspaper noted that the survey was conducted as Diet action on the government's plan to reorganize the Japanese National Railways neared conclusion and in the midst of tax reform deliberations (see note in this issue). Support for the cabinet had been consistently high from March 1984 through June 1986. It was one factor behind Mr. Nakasone's double election strategy of last July. The same survey, however, indicated approval for the Liberal Democratic Party was at a high 55 percent, unchanged from the paper's previous three surveys. (The Japan Socialist Party remained far behind in second place at 18 percent.)

Another survey by the Kyodo News Service showed cabinet support at very high levels: 54.9 percent, less than one percentage point off from its September survey. Kyodo's results were also favorable for the LDP, with public support for the party well above 50 percent and about three times that of the JSP.

Explaining these discrepancies is something of a challenge, particularly in view of the widely held perception that Mr. Nakasone is a popular figure in

Japan. The Kyodo polls consistently have registered higher support levels for the Nakasone cabinet than the Asahi surveys, although the general trends have been in harmony. One possible interpretation is that while the prime minister is widely admired, the policies of his government are generating increasing opposition from voters. Another alternative is that the "magic" of the Nakasone years has faded somewhat, leading some well-informed observers to suggest that he may indeed step down from office next June rather than see his popularity -- and therefore influence -- wane any further. In any event, the overall thrust of current government policies is unlikely to change as a result of the surveys.

Michael W. Chinworth

Defense Spending Hike Negotiations

According to recent Japanese press reports, the Ministry of Finance and the Japan Defense Agency are in the midst of intense negotiations over the size of the fiscal 1987 defense spending increase. MOF reportedly seeks a hike of no more than 4 percent while JDA is aiming for at least 7 percent. Both sides apparently are using the same circumstances to justify their positions. The outcome of the discussions could affect the defense issue significantly in Japan.

MOF hopes to limit next year's increase because certain JDA expenses -- fuel costs, for example -- are falling dramatically as a result of lower prices and the strengthened yen. JDA, however, is using the same argument to call for bigger increases. The agency says that reduced costs could enable the Self-Defense Forces to expand inflight training times, which have fallen gradually over the last decade, in part because of higher fuel prices and tight budgets.

The size of next year's increase could also precipitate still another debate over the viability of Japan's longstanding policy of limiting overall defense spending to one percent of the country's gross national product. Slower-than-expected economic growth in recent years, particularly in 1986, and significant budget increases have brought total defense spending close to the one percent limit; indeed, the ceiling may have been exceeded already. The Nakasone cabinet has vowed to honor the restriction as far as possible but has moved away from the policy in symbolic terms by referring to it as a guideline rather than a strict limit. Should slow growth continue, a 7 percent hike could bring defense spending over that level. In fact, one reason for MOF's position may be that it intends to bring defense spending back within the one percent figure.

While these negotiations continued, the Japanese delegation on the Strategic Defense Initiative completed a second round of discussions in Washington. Business leaders are concerned that Japanese companies might be unable to benefit commercially from their involvement in the program if the Department of Defense places severe restrictions on the repatriation of SDI-generated technology. The first delegation came through Washington in late October, primarily to set the stage for future talks. The Japanese government officially agreed to allow Japanese companies to participate in the SDI research program in early September, shortly after JDA director general Yuko terms of price-performance ratios and the company has a large library of software; CDC has no units in operation in Japan. Of the six Cray supercomputers installed in Japan, just three are owned by publicly funded organizations -- the University of Nagoya, the University of Tokyo and Nippon Telegraph and Telephone Corp. (The other three Crays belong to Mitsubishi Research Institute, Toshiba Corp. and Nissan Motor Co., Ltd.) Moreover, no government-financed body has ordered a Cray since NTT's X-MP was delivered in August 1984.

Equally disturbing to Cray and CDC is the toehold Fujitsu and NEC have gained in the supercomputer market outside Japan. As of mid-1986 Fujitsu reported that it had received orders from 14 foreign customers through affiliate Amdahl Corp. and West Germany's Siemens AG. For its part NEC has won one contract from an American organization -- the Houston Area Research Center, a consortium of four Texas universities. Probably more than any other single development, this January 1986 contract award transformed supercomputers into a bilateral trade issue since HARC was reportedly planning to buy an American-made system until NEC came in with what Cray and CDC executives felt was an unfairly low bid.

While the two supercomputer manufacturers were reluctant to go public with their suspicions, corporate executives did raise the matter with members of the administration's trade "strike force," which was set up in September 1985 to identify unfair foreign trade practices that the White House could then pursue by self-initiating investigations. Starting off with the U.S. industry's specific complaint, the strike force broadened its focus to include the possibility that Japan may be targeting markets at home and abroad by protecting and promoting its supercomputer industry. The group finally recommended that President Reagan take action, but in deciding to self-initiate an investigation the White House took the least confrontational route available -- a Section 305 fact-finding inquiry.

Susan MacKnight

White House Fills In Blanks In Machine Tool Plan

On December 16 President Reagan detailed what he called a comprehensive government plan to encourage modernization of the U.S. machine tool industry. The centerpiece of the program is the restraint arrangement negotiated with Japan (see JEI Report No. 44B, December 5, 1986), which is outlined below. Another major component is the agreement worked out with Taiwan to limit its U.S.-bound exports. This pact mirrors the main provisions of the five-year accord with Tokyo. Effective January 1, 1987, Taiwan will restrict shipments of milling machines and manual lathes to their 1981 U.S. market shares and will hold exports of numerically controlled lathes and machining centers to last year's market shares.

The administration also notified West Germany and Switzerland that their shipments in certain product lines must be maintained at specified levels for the next five years after these two countries refused to negotiate voluntary restraint arrangements with Washington. In addition, the White House put other foreign suppliers on notice that their exports will be monitored to insure that they do not try to capitalize on the limits on deliveries from Japan, Taiwan, West Germany and Switzerland. Backing up this warning, the president indicated that he was prepared to take appropriate unilateral action to restrain imports from these third-tier suppliers.

Department of Commerce analysts estimated that the various import restraint measures would boost U.S. capacity utilization in key computer-controlled machine tool product lines (lathes, machining centers and punching and shearing machines) from 41 percent to 60 percent. They projected as well that these steps would lead to $800 million in "additional revenue opportunities" for American builders during the life of the program.

In a companion move, the president also outlined a "domestic action plan" development by Commerce and the Department of Defense. The purpose of this plan, he noted, is to complement the industry's own modernization efforts by integrating the domestic industry more fully into the defense procurement process; linking industry programs with existing DOD programs to improve manufacturing technologies; and providing up to $5 million annually for the next three years in matching funds to support the private sector's National Center for Manufacturing Sciences.

Susan MacKnight

Commerce Department Fact Sheet on Arrangement with Japan

Japan has agreed to restrict exports of the following high technology machine tools to its 1981 U.S. market share levels:

Category	Agreement Level	1985 Level	Market Share Reduction
Numerically Controlled Lathes	57%	66%	9 points
Machining Centers	52%	73%	21 points
Numerically Controlled Punching and Shearing Machines	19%	43%	24 points

Japan has also agreed not to exceed its 1985 market shares for the following product categories:

Category	Agreement Level
Milling Machines	3%
Manual Lathes	5%
Manual Punching and Shearing Machines	9%

The value of all these reductions in Japanese exports is about $159 million per year, or about $795 million over the five year VRA period assuming constant demand.

Projection of U.S. apparant consumption for each arrangement product will be based on Commerce Department statistics. We have agreed to consult with the Japanese to select an independent forecaster to make such projections.

Machine tool kits will be counted against overall category limits. Further, the Japanese have agreed to work with us on subassemblies to insure that they do not exceed 1985 levels and impair the purpose of the agreement.

Japan will require export licenses for the three high technology product categories and will provide administrative guidance to manufacturers regarding the other product categories. During the remainder of 1986, no export licenses will be required for any products; however, Japan has agreed not to allow a surge in exports.

During 1987 and 1988 Japan will be able to export a limited number of additional machining centers and NC punching and shearing machines. With regard to machining centers, it will be able to export an additional 100 units in 1987 based on likely short supply problems.

During each year of the VRA, there will also be a joint set-aside of 1.5 percent of the market for machining center kit imports that lead to new investment and full machine tool production in the United States. This could give Japanese suppliers an additional 1.5 percent of the U.S. machining center market if they demonstrate that 1.5 percent of their exports lead to new machine tool production in the United States. However, they could also lose 1.5 percent of their market share if they do not qualify.

With regard to NC punching and shaearing machines, Japanese producers will be able to export an additional 60 units in 1987 and 30 in 1988 provided they are shipped to U.S. original equipment manufacturers. This is designed to help these U.S. companies phase out imports.

The impact of these additional factors would mean between 190 and 230 additional units imported from Japan during the first year of the VRA, valued between $19 and $22 million. The total impact of these factors over five years would amount to between 190 and 500 additional units, valued between $19 and $51 million.

The VRA will run for five years beginning January 1987 with a joint review after three years. (U.S. agreement would be required to amend the terms of the VRA.) During the transition period from June through December 1986, Japan will not issue licenses to exporters, but will be required to limit shipments to their 1985 share of the U.S. market.

The VRA specifies that imports must be maintained with the 1985 product mix in order to prevent shifts into higher-valued categories. It also includes other administrative provisions we consider essential to maintain the overall integrity of the VRAs.

As part of this VRA, we have agreed that the United States will not impose unilateral trade controls under Section 232 of the 1962 Trade Expansion Act provided that the VRA is implemented and enforced effectively. Further, we have agreed to monitor imports from other countries and insure that these countries do not capture Japan's market share.

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JEI

REPORT

NO. 1A January 9, 1987

JAPAN'S DEFENSE INDUSTRY

Summary

Japan's defense industry remains constrained by the twin effects of government budgetary policies and limited production capacity. Although defense production is only a miniscule part of the country's total industrial output, it is a significant element in certain key sectors and therefore important to the overall economy. With Japanese participation in the U.S. Strategic Defense Initiative a likelihood and a decision regarding production of a new fighter support aircraft nearing, the domestic industry will soon have an opportunity to "show its stuff."

This report, the first in a two-part summary of Japan's defense industry, examines the major players; recent production trends; and the interrelation of production and defense policy decisions. The second part, to be published later in the year, will address the effects of policy constraints on the overseas activities of defense contractors.

Market Characteristics

As even casual observers of Japanese defense policies know, the country's total defense spending has been limited since 1976 to an amount equal to 1 percent of the country's gross national product. Economic growth has enabled the defense budget to reach a significant level (see Table 1), but manpower requirements consume nearly half of the Japan Defense Agency's total spending

(45.1 percent of fiscal 1985's budget, for example), reducing the amount available for procurement (see Table 2).

Table 1: Japan's Initial Defense Budget, FY 1955-FY 1987

Fiscal Year	Budget (billion yen)	Percent Change	Budget/GNP Ratio
1955	Y134.9	-3.3%	1.78
1965	301.4	9.6	1.07
1975	1,327.3	21.4	0.84
1980	2,230.2	6.5	0.90
1981	2,400.0	7.6	0.91
1982	2,586.1	7.8	0.93
1983	2,754.2	6.5	0.98
1984	2,934.7	6.6	0.99
1985	3,137.2	6.9	0.99
1986	3,343.6	6.6	0.99
1987 (est.)	3,517.4	5.2	1.00

Source: Japan Defense Agency, Defense of Japan, 1985; Japan Times, December 31, 1986.

Table 2: Allocation of Japan's Defense Expenditures (Initial Budget), FY 1981-FY 1985

Category	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985
Personnel	47.7%	46.6%	44.5%	44.6%	45.1%
Supplies	52.3	53.4	55.5	55.4	54.9
Equipment acquisition	22.5	22.4	24.9	26.3	26.2
Research and development	1.0	1.1	1.1	1.2	1.6
Facility improvement	2.2	2.3	1.9	1.3	1.4
Maintenance	14.7	15.8	16.3	15.5	15.1
Base countermeasures	10.5	10.4	10.0	9.7	9.5
Other	1.5	1.4	1.3	1.3	1.2
Expenditures (billion yen)	Y2,400.0	Y2,586.1	Y2,754.2	Y2,934.7	Y3,137.2

Source: Japan Defense Agency, Defense of Japan, 1985

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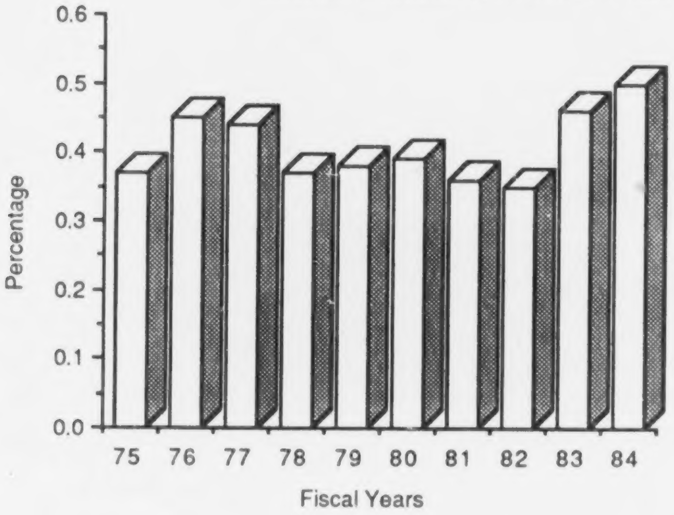
This spending cap has limited the growth of the defense market in Japan. Although allocations for equipment procurement have increased in recent years, it is highly unlikely that total defense spending will increase to the level necessary to produce dramatic hikes in equipment budgets, given the serious international and domestic political constraints on Japan's defense policies. Defense production accounts for just 0.5 percent of Japan's total industrial output, although it has been edging upward over the past five years (see Figure 1).

Figure 1: Defense Production as Percent of Total Industrial Production, FY 1975-FY 1984



Source: *Boei Nenkan, 1986*

For individual companies, defense sales are not a significant percentage of total sales, even for major contractors. For example, Japan's largest defense contractor is Mitsubishi Heavy Industries, Ltd., with Y242 billion ($1.1 billion at FY 1985's average exchange rate of Y221.09=$1.00) in contracts in FY 1985. This figure, however, pales in comparison with the company's total sales of Y1,831.6 billion ($8.3 billion). This is in distinct contrast with leading American defense contractors, whose absolute dollar sales in some cases dwarf JDA's total procurement budget and constitute the bulk of the company's total revenues.

However, in certain sectors defense-related activities are critical, particularly in the aerospace industry. In 1985, 83.8 percent of the value of Japanese aircraft production went to the military, known as the Self-Defense Forces. This pattern has fluctuated over the last 10 years, but at no time in recent memory has the percentage fallen below 75 percent. Military production is likely to remain dominant for years to come.

In the boom-and-bust shipbuilding industry, just over 4 percent of total production in terms of value is allocated to defense. The trend has generally been upward over the last decade, leveling off in the last four fiscal years. SDF contracts -- while limited -- are stable and provide an important, steady source of business for Japanese shipyards, which in recent years have been faced with mounting competition from other countries in the civilian sector. At the very least, defense orders serve as a cushion in the leaner years -- an economic role that is likely to continue in the future.

Market Participants

The number of players in the Japanese defense market is limited. Mitsubishi Heavy Industries is by far the most important contractor, accounting for one-fourth to one-third of all defense production over the last several years. The top 10 contractors account for about 80 percent of total outlays (see Table 3). Nevertheless, the number of suppliers to the military is growing for several reasons. One is that much of the research and development

Table 3: Top Japanese Defense Contractors, FY 1984 and FY 1985

(in billions of yen)

FY 1984	Amount
1. Mitsubishi Heavy Industries, Ltd.	Y235.9
2. Kawasaki Heavy Industries, Ltd.	102.7
3. Ishikawajima-Harima Heavy Industries, Ltd.	93.3
4. Mitsubishi Electric Corp.	92.3
5. Toshiba Corp.	60.6
6. NEC Corp.	43.2
7. Japan Steel Works, Ltd.	23.6
8. Sumitomo Heavy Industries, Ltd.	22.1
9. Hitachi Zosen Corp.	20.5
10. C. Itoh Aviation Co., Ltd.	19.5
Total for Top Contractors	713.7

FY 1985	Amount
1. Mitsubishi Heavy Industries, Ltd.	Y242.0
2. Kawasaki Heavy Industries, Ltd.	123.4
3. Mitsubishi Electric Corp.	104.7
4. Toshiba Corp.	73.3
5. Ishikawajima-Harima Heavy Industries, Ltd.	69.4
6. NEC Corp.	40.5
7. Japan Steel Works, Ltd.	28.6
8. Sumitomo Heavy Industries, Ltd.	22.4
9. Hitachi Zosen Corp.	21.6
10. Fuji Heavy Industries, Ltd.	17.7
Total for Top Contractors	743.6

Source: Jieitai Sobi Nenkan, 1985 and 1986.

capability and production capacity are located in the private sector. JDA has its own R&D facility but, as discussed below, its resources are limited. Consequently, the agency tends to look to the private sector for much of the needed know-how and technology, particularly as defense needs have grown more sophisticated and diverse.

That diversification increases the number of companies interested in defense-related work. In areas such as intelligence and surveillance, advanced electronics, for example, plays a critical role. Most of the defense-applicable developments in this field have come from the commercial sector where Japan's prowess is unquestioned. As companies have produced new commercial advances, their military usefulness to JDA has also increased. The nature of defense advances is such that the line between a great many purely commercial and defense products is becoming indistinguishable. The implications of this trend are particularly important, given the limited size of Japan's defense industry. Consequently, the line between defense contractors and private-sector companies is becoming blurred and the number of potential defense contractors is increasing.

Government policy emphasis also influences the number of participants in the market and their respective roles. With self-sufficiency occupying such a high priority in both private-sector and policymaking circles, it makes sense from a policy perspective to diversify the pool and capabilities of potential defense contractors. This is not "industrial policy" in action, but the result is to create an infrastructure of firms that can handle Japan's defense needs.

In aircraft production, Mitsubishi Heavy Industries, Kawasaki Heavy Industries, Ltd. and Fuji Heavy Industries, Ltd. dominate. The mainstays in this sector are F-15 interceptors (MHI is the prime contractor) and P-3C anti-submarine surveillance aricraft (with KHI as the lead contractor). Fuji Heavy Industries plays the primary role in the production of the AH-1S antitank helicopter. Japan Aircraft Manufacturing Co., Ltd. -- a KHI affiliate -- participates in fuselage production. Ishikawajima-Harima Heavy Industries Co., Ltd. dominates the market for jet engines, producing over 70 percent, while KHI and MHI produce the remainder. KHI also is the prime contractor for the T-4 trainer, a domestically developed aircraft.

Five major shipbuilders supply the Maritime Self-Defense Forces: MHI, IHI, Mitsui Shipbuilding and Engineering Co., Ltd., Hitachi Zosen Corp. and Sumitomo Heavy Industries, Ltd. As noted earlier, orders are limited but steady. Licensed production of the U.S. Aegis escort ship offers new opportunities to Japanese manufacturers. Industry surveys suggest that initially, operations will be restricted primarily to basic construction tasks, with a heavy reliance on U.S. electronics and weapons systems. However, the same surveys imply that Japanese companies will try to replace imported components with domestic systems as soon as possible.

An important move with distinct implications for domestic contractors is JDA's decision to introduce Raytheon Co.'s Patriot surface-to-air missile system. MHI will lead the production effort, with Mitsubishi Electric Corp., NEC Corp. and Toshiba Corp. playing important roles. Missile development has been an area of great importance to Japanese manufacturers and the spin-offs in terms of know-how from Patriot production could be sizable.

Research and Development

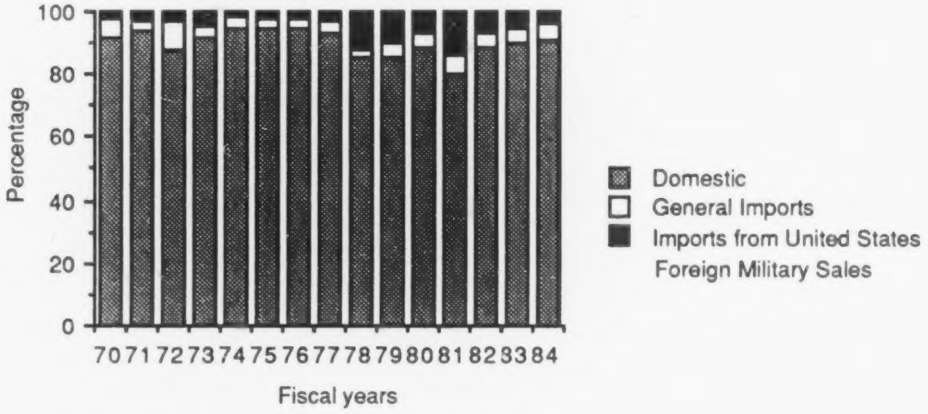
Government-sponsored military R&D is very limited in Japan, but effective given the resources available. JDA's Technical Research and Development Institute is primarily responsible for these activities, but its resources amount to less than 2 percent of the agency's total budget -- Y50.4 billion ($228 million) in FY 1985. (To put this in perspective, the Pentagon's total spending on R&D in FY 1986 will exceed $39 billion, with SDI-related contracts alone accounting for more than $3 billion.) The agency has 970 employees, 530 of whom are actually involved in research. It places the same emphasis on domestic participation as does the general procurement budget. TRDI projects have included the development of the M-79 antitank missile, the F-1 fighter support aircraft, the T-4 trainer and the C-1 jet transport.

Japan is about to embark on a very important project -- the development of a new generation of fighter support aircraft to replace outdated F-1s and perhaps F-4s. The project has been dubbed "FSX" and a decision regarding the plane to be selected is imminent. McDonnell Douglas Corp.'s F-18 appears to be in the running, along with the F-16 made by General Dynamics Corp. (The European Tornado is said to have been eliminated from the competition in the early stages.) Most observers believe, however, that JDA will opt for a plane that can be built largely by domestic contractors, or a U.S.-Japan co-developed plane based on the F-18. The most significant foreign participation will be in supplying engines for the new jet -- still a major limitation in the Japanese aircraft industry.

Domestic Procurement

JDA has emphasized domestic procurement whenever feasible, including licensed production in Japan of foreign -- usually American -- systems. The defense agency spends more than 80 percent of its funds domestically (see Figure 2); the figure is as high as 99 percent in some areas. While most of its

Figure 2: Breakdown of Defense Procurements, FY 1970-FY 1984



Source: *Boei Nenkan, 1986*

"big ticket" purchases are systems developed in the United States, licensed or domestically produced systems are favored over "off-the-shelf" purchases, despite the potential cost advantages of direct purchases from abroad.

The reasons for this emphasis on domestic production vary. For industry, clearly the motive is in part related to profits and guaranteed markets. As business dries up in other sectors, manufacturers are looking to new areas to take up the slack. Defense assures contractors of steady markets in the future. This is particularly true given the predictability of Japan's defense policies. Procurement goals follow the 1976 National Defense Program Outline (see Tables 4 and 5), assuring production stability and long-term markets. Furthermore, national security dictates the necessity to maintain sufficient domestic production capabilities so as to preclude the possibility of being dependent on overseas producers. The defense production committee of Keidanren (the Federation of Economic Organizations -- Japan's most important business organization) has consistently taken this position, and JDA's 1985 white paper also referred to the need for self-sufficiency in defense production.

Another factor concerns the proliferation of defense-applicable products by the commercial sector. As defense systems grow more complicated, commercial suppliers in many high technology fields are finding potential markets for their products in the defense sector. For example, Sony Corp., while known for its "Walkman" and other consumer innovations, is finding the military a potential customer for a variety of products, and not just color televisions.

Patriotism may also factor into the equation. For example, even the generally liberal Asahi Shimbun -- a frequent critic of government defense policies -- reports with a smattering of pride on the steady advance toward domestic production of the FSX. Although it remains a nebulous -- and potentially sensitive -- area, the implications for domestic production cannot go unnoticed.

The final consideration is the United States. Policymakers in the Defense Department are generally reluctant to advertise their views, but there is more than a little support in the Pentagon for a significant defense industry in Japan, in part to supplement U.S. capabilities. Defense Secretary Caspar Weinberger has further endorsed the notion of interoperability of Japanese and American defense systems. Given the established pattern of domestic defense production in Japan, it is logical to conclude that DOD will not object to an expansion of the country's defense production base.

There have been frequent charges that defense production is little more than a means for Japan to develop certain industries that ultimately will compete with their American counterparts, particularly in commercial aircraft (see JEI Report No. 39A, October 14, 1983). A 1982 study by the U.S. General Accounting Office concluded that the technology transfers from programs such as the co-production of the McDonnell Douglas F-15 significantly enhanced private-sector aircraft production capabilities (see Table 6). American journalists, observing that MHI's MU-300 Diamond business jet is assembled next to the F-15 production line, have not been able to resist suggesting that McDonnell Douglas technology has found a home -- with MHI's help -- in that civilian plane.

Japanese executives and many DOD officials downplay such conclusions. One Japanese corporate official wistfully noted that "perhaps MU-300 sales

Table 4: Force Levels Stipulated by 1976 National Defense Program Outline

Classification	Level Stipulated in NDPO	Achieved FY 1985
Ground Self-Defense Forces		
Authorized personnel	180,000	180,000
Units deployed regionally in peacetime	12 divisions	12 divisions
	2 composite brigades	2 composite brigades
Mobile operational units	1 armored division	1 armored division
	1 artillery brigade	1 artillery brigade
	1 airborne brigade	1 airborne brigade
	1 training brigade	1 training brigade
	1 helicopter brigade	1 helicopter brigade
Low-altitude surface-to-air missile units	8 anti-aircraft artillery groups	8 anti-aircraft artillery groups
Maritime Self-Defense Forces		
Anti-submarine surface ship units (for mobile operations)	4 escort flotillas	4 escort flotillas
Anti-submarine surface ship units (regional district units)	10 divisions	10 divisions
Submarine units	6 divisions	6 divisions
Minesweeping units	2 flotillas	2 flotillas
Land-based anti-submarine aircraft units	16 squadrons	14 squadrons
Anti-submarine surface ships	60 ships	60 ships
Submarines	16	15
Combat aircraft	220	190
Air Self-Defense Forces		
Aircraft control and warning units	28 groups	28 groups
Interceptor units	10 squadrons	10 squadrons
Support fighter units	3 squadrons	3 squadrons
Air reconnaissance units	1 squadron	1 squadron
Air transport units	3 squadrons	3 squadrons
Early warning units	1 squadron	1 squadron
High altitude surface-to-surface air missile units	6 groups	6 groups
Combat aircraft	430	400

In establishing the force levels above, the Outline makes the following assumptions about the international situation and the necessity for a self-defense program:

- The major power blocs will continue a dialogue toward improving relations and reducing the threat of nuclear war.
- Despite this trend, regional instability will remain and the international situation will continue to be fluid.
- An equilibrium exists among the United States, China and the Soviet Union in the area around Japan.
- There is little possibility of a full-scale conflict between East and West due to the military balance, including the nuclear balance.
- While the possibility of regional conflict cannot be dismissed, the U.S.-Japan security arrangement helps maintain international stability and prevents full-scale aggression against Japan.

Source: Japan Defense Agency, Defense of Japan, 1985

Table 5: Weapons Procurement Plan, FY 1986-FY 1990

	Total End of FY 1985	Procure FY 1986-FY 1990	Retire FY 1986-FY 1990	Total End of FY 1990
Ground Self-Defense Forces				
Main battle tanks	1,146	246	187	1,205
Heavy guns	2,161	277	231	2,207
Armored personnel carriers	639	310	---	949
Surface-to-surface missiles	---	54	---	54
AH-1S helicopters	32	43	1	74
CH-47J helicopters	5	24	---	29
Hawk missiles (Type one)	4.5	---	0.5	4
Hawk missiles (Type two)	---	4.5	---	4.5
Maritime Self-Defense Forces				
Destroyer frigates	58	9	5	62
Submarines	14	5	3	16
Other vessels	97	21	25	93
Total vessels	169	35	33	171
P-3C ASW aircraft	49	50	5	94
ASW helicopters	64	66	29	102
MH-53E minesweeping helicopters	---	12	---	12
Other tactical aircraft	31	---	25	6
Tactical aircraft (total)	145	128	59	214
Air Self-Defense Forces				
F-15J/DJ fighters	115	63	15	163
CH-47J helicopters	2	12	---	14
E-2C AEW aircraft	8	5	1	12
Other tactical aircraft	239	---	27	212
Total tactical aircraft	372	87	44	415
T-4 trainer	---	93	---	93
Patriot missile group	0.5	5.0	---	5.5

Source: Japan Defense Agency, Defense of Japan, 1985

Table 6: Examples of U.S.-Japan Defense Co-production

U.S. Company	Japanese Company	Component/System	Dates of Validity
McDonnell Douglas Corp.	Daicel Chemical Industries, Ltd.	F-15 aircraft assemblies	10/79-09/94
Goodyear Aerospace Corp.	Mitsubishi Precision Co., Ltd.	F-15J simulators	08/79-08/94
Bendix Corp.	Ishikawajima-Harima Heavy Industries Co., Ltd.	T-56 engine parts; P-3C aircraft	08/79-08/89
TRW Inc.	Ishikawajima-Harima Heavy Industries Co., Ltd.	F-15 electromechanical parts	07/79-07/94
Texas Instruments Inc.	Mitsubishi Electric Corp.	Magnetic detecting systems	06/79-06/81
Litton Systems Inc.	Toshiba Corp.	AN/ASN-109 (LTN) INS for F-15	05/79-05/89
Teledyne Industries Inc.	Mitsubishi Electric Corp.	AN/APN-217 Doppler navigation set	05/79-05/89
Lear Siegler Inc.	Kanto Aircraft Instrument Co., Ltd.	Automatic flight controls, P-3C	04/79-04/89
General Electric Co.	Toshiba Corp.	F-15 gyro systems	04/79-03/94
Raytheon Co.	Hitachi, Ltd.	DE-1160B sonar	09/79-08/86
IBM Corp.	IBM Japan Ltd.	Data processing/encryption equipment	01/77-12/83
Honeywell Inc.	Japan Aviation Electronics Industry, Ltd.	HDC-301 computers	08/78-08/88

Source: U.S. General Accounting Office, U.S. Military Coproduction Programs Assist Japan In Developing Its Civil Aircraft Industry, March 18, 1982.

would have been better" if potential buyers mistakenly believed it incorporated F-15 technology. Addressing the technology transfer issue in the context of the SDI debate, Nathan Glazer of American University recently suggested that such flows are an inevitable part of the process, adding that individual companies should take appropriate measures to protect the most vital aspects of their systems and assure reciprocity in technology flows. A DOD official concurs, belittling corporate naivete. "We're all big boys and girls," he concludes.

In any case, a 1984 Defense Science Board report noted the pattern of national production and the likelihood that it will continue. It declared that a thorough understanding of Japan's drive for technological self-sufficiency, particularly in defense, is essential for American policymakers and contractors to achieve realistic technology exchanges with Japan. The report underscored the Japanese government's role in high technology, its drive to develop self-sufficiency in defense production and the perceived link between commercial and defense projects.

Japanese R&D efforts also have accelerated in anticipation of restricted access to U.S. technology in the future. Despite its miniscule budget, JDA's Technical Research and Development Institute is attempting to expand its research pool to enable the government and private sector to approach potential U.S. partners on an equitable basis, offering technology swaps when necessary instead of simply seeking licenses of valued U.S. systems for production in Japan.

The self-sufficiency drive is beginning to pay off. The SSM-1 surface-to-surface missile essentially is a home-grown product, developed far more quickly and cheaply than comparable foreign systems. Japanese contractors are making significant advances in communications, remotely piloted vehicles, avionics and other electronics systems. The new modern tanks -- domestic products again -- are considered at least as reliable as comparable U.S. vehicles (although somewhat dated in certain respects). Even the high cost of producing F-15s under license -- about $65 million each, or twice the U.S. price -- is justified by their longer effective lives and lower maintenance costs. Indeed, industry surveys claim that efficiency improvements in the F-15 production process have been sufficient to bring the cost of the plane in line with the U.S. version. Furthermore, savings are claimed in maintenance through both the existence of a strong domestic capability and the higher operating rates of the Japanese planes.

The FSX project clearly is Japan's most ambitious attempt at 100 percent domestic production of a major defense system. While it is unlikely that Japanese industry is independently capable of producing a top-flight alternative to the F-18, its drive toward that goal is demonstrated by the FSX program. The significant consideration is that government and industry have acquired sufficient experience and know-how to seriously explore that possibility.

The FSX program has been highly controversial from the start. Many Japanese and overseas observers have suggested that performance requirements for the new jet were intentionally designed to favor the domestic production option, with MHI playing a major lobbying role. The costs of the program are difficult to estimate, but will be more than $1 billion. (In comparison, JDA's R&D unit spent $289 million on airframe and engine development for the T-4 trainer over the FY 1980-FY 1982 period.) The costs are such that a major increase in Japan's defense budget may be needed if more fundamental programs -- include sustainability -- are not to be neglected.

Nevertheless, Japanese aircraft manufacturers clearly expect to concentrate on the FSX for the foreseeable future. Some Japanese industrialists felt they shortchanged their companies by opting for co-production of imported systems for certain major projects -- particularly the P-3C aircraft -- and they do not want to miss what they see as a major opportunity to give the industry a boost -- perhaps the boost necessary to become competitive with overseas manufacturers.

Future Trends

Many private-sector interests view SDI participation as a way to retain their access to critical technological improvements and perhaps assess their own capabilities. (The implications of participation in SDI will be examined in the second part of this report.)

Beyond SDI, the trends in the Japanese defense industry in part can be predicted by examining the missions of the Self-Defense Forces' three branches. For example, the surveillance needs dictated by the goal to extend protection to the sealanes approaching Japan to a distance of 1,000 nautical miles coupled with a Japanese penchant for technology make it likely that a decision will be forthcoming in the near future on advanced airborne surveillance systems. The P-3Cs, while generally regarded as reliable surveillance aircraft, have significant duration and range limitations, making the aircraft extremely vulnerable.

Given this combination of elements, it is likely that defense officials will consider seriously the introduction of sophisticated airborne warning and command systems (AWACS) instead of simply increasing the number of P-3Cs. Britain's recent decision to purchase Boeing Co.'s AWACS could influence the course of policy and procurement considerations in Japan. Furthermore, given the emphasis on domestic production and the desire to wean Tokyo from U.S. "black box" dependency, the decisions regarding the AWACS and its ultimate successor could mirror many of the elements of the FSX debate.

The policy of the Nakasone government of "meeting a threat at sea" implies increased emphasis on naval units, but this will not necessarily translate into massive boosts in ship construction -- even though naval budgets are slowly increasing relative to the other branches of the SDF. Instead, it tends to support already established trends in the surveillance areas, missile production and development of fighter support aircraft. The 1,000-mile sealane goal could impact on the industry in other respects as well, including inflight refueling capabilities. Other areas of importance include development and introduction of long-range radar systems, such as over-the-horizon radar systems with ranges in excess of 2,000 miles.

Outlook

As indicated by the most recent round of budget discussions in Japan, defense spending is increasing but each advance is limited and often painful.

Breaching the 1 percent barrier is very important symbolically, but its long-term importance remains to be seen. Contrary to initial press reports, achieving a level of spending equal to 1.004 percent of GNP instead of 0.997 does not mean that the floodgates are suddenly open to defense spending. Nevertheless, it does maintain an established trend and it will facilitate future lobbying efforts by defense-related interests.

Direct government contracts will remain limited due to budget and political constraints, not to mention the government's adherence to a policy of procuring only enough equipment to assure the minimum level of defense necessary for the country. As the sophistication of defense and commercial systems grows, however, the de facto number of potential contractors will increase. For this and other reasons, developments in the domestic industry will be worth watching for years to come.

For further information, contact Michael Chinworth.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix

Defense Spending by Selected Countries as Percent of Gross Domestic Product, 1971 and 1984

	1971		1984		Percent Change
Country	Percent	Rank	Percent	Rank	1971-84
Greece	4.7%	4	7.2%	1	53.8%
United States	7.1	2	6.5	2	-7.6
United Kingdom	4.9	3	5.3	3	8.0
Turkey	4.5	5	4.4	4	-3.1
France	4.0	6	4.1	5	3.2
West Germany	3.4	9	3.3	6	-2.6
Portugal	7.4	1	3.3	7	-56.0
Netherlands	3.4	7	3.2	8	-6.2
Belgium	2.9	10	3.2	9	11.2
Spain	---	--	2.9	10	n.a.
Norway	3.4	8	2.8	11	-16.3
Italy	2.7	11	2.7	12	-0.7
Denmark	2.4	12	2.3	13	-5.0
Canada	2.2	13	2.2	14	-3.1
Luxembourg	0.8	15	1.2	15	50.0
Japan	0.8	14	1.0	16	20.4
Non-U.S. NATO	3.6		3.5		-0.5
Non-U.S. NATO and Japan	3.0		2.8		-6.1
Total NATO	5.5		5.2		-5.0
Total NATO and Japan	5.0		4.6		-8.4

Source: Department of Defense, Report on Allied Contributions to the Common Defense: A Report to United States Congress, March 1986.

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Cabinet Adopts Austere FY 1987 Budget

On December 30 the cabinet adopted a general account budget for FY 1987 (beginning April 1, 1987) that will raise total spending a miniscule 0.02 percent in nominal terms over the initial budget for the current fiscal year. It is the smallest increase in 32 years, a reflection of Prime Minister Yasuhiro Nakasone's determination to reduce the deficit. Substantial increases, however, are penciled in for official development assistance and defense spending (see article in this issue). With more than 300 seats in the 512-member lower house of the Diet, approval of the budget bill is assured.

The general account budget (discretionary expenditures, transfers to local governments and debt service costs) is set at Y54,101 billion ($338.1 billion at Y160=$1.00) in FY 1987 (see Table 1), a slight increase of Y12.4 billion ($77 million). Increased debt service costs, which are expected to account for 20.9 percent of total spending, more than offset declines in discretionary spending and transfers to local government. On the revenue side, the government expects a 1.6 percent rise in tax receipts to offset a decline in non-tax revenues and allow a modest reduction in government bond issues (see Table 2). These figures, though, are based on 3.5 percent real growth in FY 1987, which many private economists believe is too optimistic.

Table 1: Japan's General Account Expenditures, FY 1986-FY 1987

(initial budgets in millions of yen)

	FY 1986	FY 1987	Change
Debt Service	Y11,319,518	Y11,333,500	0.1%
Local Government Transfers	10,184,955	10,184,100	-0.0
Nondiscretionary	21,504,473	21,517,600	0.1
Social Security	9,834,555	10,089,556	2.6
Public Works	6,223,344	6,082,412	-2.3
Education and Science	4,844,516	4,849,687	0.1
Defense	3,343,549	3,517,434	5.2
Pensions	1,850,139	1,895,612	2.5
Economic Cooperation	623,244	649,228	4.2
(Official Development Assistance)	(622,000)	(658,000)	(5.8)
Energy Measures	629,680	495,231	-21.4
Small and Medium Enterprises	205,218	197,348	-3.8
Food Control Account	596,188	540,580	-9.3
Other Operating Expenses	4,083,737	3,916,281	-4.1
Debt Reserves	350,000	350,000	0.0
Discretionary	32,584,170	32,583,400	-0.0
Total	54,088,643	54,101,019	0.0

Table 2: Japan's General Account Revenues, FY 1986-FY 1987

(initial budgets in millions of yen)

	FY 1986	FY 1987	Change
Tax and Stamp Revenues	Y40,560,000	Y41,194,000	1.6%
Non-Tax Revenues	2,582,643	2,406,000	-6.8
Government Bonds	10,946,000	10,501,000	-4.1
Deficit-Financing Bonds	5,246,000	4,981,000	-5.1
Construction Bonds	5,700,000	5,520,000	-3.2
Total	54,088,643	54,101,019	0.0

In drafting the budget policymakers confronted the conflicting goals of boosting domestic demand and improving deficit-ridden government finances. The latter objective is reflected in the cuts slated for many government programs that will result in a fifth consecutive decline in discretionary spending (see Table 3). Other than defense and foreign aid, the only major rise came in spending for pensions and social security, reflecting the aging of Japan's population. Social security expenditures in FY 1987 are scheduled to top Y10 trillion ($62.5 billion) for the first time.

Table 3: Growth of General Account Expenditures, FY 1976-FY 1987

(change in initial budget)

Fiscal Year	General Account	National Debt Service	Local Government Transfers	Discretionary Expenditures*
1976	14.1%	60.2%	-13.6%	18.8%
1977	17.4	41.1	21.3	14.5
1978	20.3	37.2	16.8	19.2
1979	12.6	26.6	-2.0	13.9
1980	10.3	30.2	23.8	5.1
1981	9.9	25.3	23.5	4.3
1982	6.2	17.7	14.2	1.8
1983	1.4	4.6	-20.8	-0.0
1984	0.5	11.7	21.5	-0.1
1985	3.7	11.7	9.0	-0.0
1986	3.0	10.7	5.1	-0.0
1987	0.0	0.1	-0.0	-0.0

*Discretionary spending equals the general account minus debt service costs and transfers to local governments.

Table 4: Public Bond Issues, FY 1976-FY 1987

(in billions of yen, initial budget)

	Bond Issues		Dependence**		Outstanding Debt		Debt Service	
FY	Total*	Deficit-Financing	Total	Deficit-Financing	Total	Percent of GNP	Total	Percent of Spending
1976	Y7,275	Y3,750	29.9%	19.3%	Y22,076.7	12.9%	Y1,664.7	6.9%
1977	8,480	4,050	29.7	17.8	31,902.4	16.8	2,348.7	8.2
1978	10,985	4,935	32.0	18.4	42,615.8	20.4	3,222.7	9.4
1979	15,270	8,055	39.6	27.1	56,251.3	25.0	4,078.4	10.6
1980	14,270	7,485	33.5	22.0	70,509.8	28.8	5,310.4	12.5
1981	12,270	5,485	26.2	14.4	82,273.4	31.7	6,654.2	14.2
1982	10,440	3,924	21.0	9.5	86,482.2	35.4	7,829.9	15.8
1983	13,345	6,980	26.5	16.6	109,694.7	38.6	8,192.5	16.3
1984	12,680	6,455	25.0	15.2	121,693.6	40.1	9,155.1	18.1
1985	11,680	5,730	22.2	12.8	134,431.4	41.9	10,224.1	19.5
1986	10,946	5,246	20.2	11.3	145,400.0	43.4	11,319.5	20.9
1987	10,501	4,981	19.4	9.2	152,400.0	43.5	11,333.5	20.9

*Includes both construction and deficit-financing bonds.
**As percent of total revenues.

Tokyo's spending restraint will allow it to reduce the ratio of government bond issues to total revenues to 19.4 percent in FY 1987, the first year since FY 1975 that the figure has come in under 20 percent (see Table 4). It is unlikely, however, that the government will be able to end the practice of financing the budget through issues of deficit-covering bonds by FY 1990. The Y265 billion ($1.7 billion) cut scheduled for next fiscal year is far below the Y1.3 trillion ($8.1 billion) annual reduction necessary to reach the target.

The government is relying on the Fiscal Investment and Loan Program, the so-called "second budget" that is financed primarily by postal savings and public pension funds, to stimulate the economy. The FILP budget will increase 22.2 percent to Y27,081 billion ($169.3 billion), its largest increase since FY 1973. This hike will raise total expenditures 6.5 percent in FY 1987 -- up from an initial 3.9 percent gain in FY 1986, with combined outlays on public works expected to rise at least 5 percent, according to Finance Minister Kiichi Miyazawa. Some business leaders, though, were critical of the government's efforts. Noboru Gotoh, president of the Japan Chamber of Commerce and Industry, said the budget was not sufficiently stimulative to counter the deflationary impact of the yen's appreciation.

Randall S. Jones

FY 1987 Defense Spending: Not Exactly Through The Ceiling

The initial FY 1987 defense budget will increase spending to the point where it will at last exceed 1 percent of the country's gross national product, although barely. If economic growth forecasts prove correct, total defense spending for the fiscal year will reach 1.004 percent, just slightly higher than this fiscal year's level, which is estimated at 0.997 percent.

The change at this point is more significant for its symbolic importance and its potential impact on other aspects of Japan's defense policy than because of its financial impact. In bringing the defense budget to this level, the Ministry of Finance agreed to restore Y37.9 billion ($236.9 million at Y160=$1.00) that had been cut from the Japan Defense Agency's request. Although the final figure is less than the agency requested, it is likely to keep the government's Y18.4 trillion ($115 billion) five-year defense procurement plan on track for the second year. It will also allow JDA to make decisions in several key areas, including the FSX project -- the next-generation fighter support aircraft to replace aging F-1s and F-4s. Furthermore, it maintains the overall pattern of consistent defense spending increases, in contrast to many of Japan's Western allies.

Total defense outlays are set at Y3,517.4 billion ($22 billion), a 5.2 percent increase over FY 1986's initial budget. The budget includes funding for purchases of additional Patriot surface-to-air missile units; 12 of 15 requested F-15J interceptors; three C-130 transport aircraft; and 20 of 23 requested T-4 trainer aircraft. Thirty-six percent of the budget will be allocated to purchases of military equipment, a significant hike. Almost 44 percent will be earmarked for personnel costs. The Ground Self-Defense Forces will receive 36.6 percent of the total, the Air SDF 25.5 percent and the Maritime SDF 24.5 percent. These figures suggest a gradual shift to the MSDF in

Tax Reform Plan Clears Another Hurdle

Tax reform in Japan moved a step closer to implementation December 23 when the Liberal Democratic Party's Tax System Research Commission approved the details of the first major overhaul of the nation's tax code in 36 years. The package contained no major new wrinkles (see JEI Report No. 44B, December 5, 1986, and No. 46B, December 19, 1986), but this familiarity does not guarantee smooth sailing for the government's tax reform bills in the Diet. Opposition party officials have already put LDP leaders on notice that they plan to fight the proposed introduction of a broad-based sales tax modeled after the European Community's value-added tax. There could also be a backlash when voters and corporate executives figure out that the plan, while revenue neutral on paper in both FY 1987 and FY 1988, spells higher total tax payments for many individuals in FY 1988 and later years and for a long list of businesses right from the start.

Like the tax reform plan adopted last summer by the United States, the overhaul of Japan's tax system proposed by the LDP tax panel features cuts in both personal and corporate income taxes. Individual income taxes at the national and local levels will be trimmed by an estimated Y1,270 billion ($7.9 billion at Y160=$1.00) in 1987 and by an additional Y1,430 billion ($8.9 billion) or so in 1988. These cuts will be achieved in large part by reducing the number of taxable income brackets in the national tax code from the current 15 to 13 this year and 6 in 1988 and by lowering the marginal rates applicable to all tax brackets in two steps (see Table). Unlike the situation in the United States, local governments will alter their personal income tax structures in tandem with the national government.

Japan's business community also won its long-running campaign for lower statutory corporate income tax rates. Over the FY 1987-FY 1989 period companies capitalized at Y100 million ($625,000) or more with a taxable income in excess of Y8 million ($50,000) will see the rate at which retained earnings are taxed drop from 43.3 percent to 37.5 percent. Although the FY 1989 rate will still be above the pre-FY 1975 level, companies are expected to save a total of Y1,800 billion ($11.3 billion) over the next three years.

Since government and LDP policymakers were in agreement that any overhaul of the tax code must be revenue neutral, tax planners were saddled with the tough job of finding ways to make up the Y4,500 billion ($28.1 billion) revenue loss expected from the cuts in personal and corporate income taxes. Introduction of a major new indirect tax was the top candidate from the start, but just the mention of this option triggered the same storm of criticism that had torpedoed previous government attempts to narrow the yawning budget deficit by enacting a new sales tax. This time around, though, the LDP tax council, like the government's tax panel before it, decided to bite the bullet.

Included in the tax reform package approved by the LDP's tax commission is a 5 percent value-added or sales tax that will be applied at each stage of the production process and on most service-sector transactions starting on January 1, 1988. To make the tax more politically palatable, the group opted to exclude from coverage a total of 43 items that can be generally described as basic living costs -- for example, food, rent, public transportation, education, medicine and medical care covered by the national health insurance system. Companies with annual sales of Y100 million ($625,000) or less will also be exempted from the system.

Proposed Tax Changes for FY 1987

Tax Cuts

National Taxes	
Personal Income Taxes	¥1,000 billion
• Reduction in the number of taxable income brackets from 15 to 13 effective January 1987	
• Cuts in marginal tax rates above the minimum 10.5 percent rate (taxable income of ¥0.5 million or less), with the maximum rate dropping from 70 percent to 60 percent on taxable income over ¥50 million as of January 1987	
• Deduction of ¥112,500 in spousal taxable income for a married couple with a taxable income of less than ¥8 million	
Corporate Income Taxes	400 billion
• Reduction of the basic tax rate for retained earnings from 43.3 percent to 42 percent	
• Increase in the basic tax rate for distributed earnings from 33.3 percent to 34 percent	
Local Taxes	
Personal Income Taxes	270 billion
• Reduction in the number of prefectural and municipal taxable income brackets from 15 to 11	
• Cuts in marginal tax rates above the minimum, which will go up from 4.5 percent to 5 percent, with a new top rate of 17 percent instead of 18 percent	
• Increase in the exemption (credit) for taxpayer, spouse and dependents from ¥260,000 each to ¥280,000 each	
Corporate Income Taxes	70 billion
Total	1,740 billion

Tax Increases

National Taxes	
Taxes Paid by Individuals	750 billion
• Introduction of a 5 percent value-added (sales) tax January 1, 1988 (¥650 billion)	
• Surcharge of 6 percentage points on value-added (sales) tax on motor vehicles starting January 1, 1988 (¥50 billion)	
• Introduction of a 20 percent withholding tax on interest income from postal savings and bank time deposits effective October 1, 1987 (¥50 billion)	
Taxes Paid by Businesses	650 billion
• Changes in the securities transaction tax, registration and license tax and other business taxes (¥300 billion)	
• Phase-out of tax-free reserves for bonuses (¥350 million)	
Total	1,400 billion

Proposed Tax Cuts for FY 1988

National Taxes

Personal Income Taxes

- Reduction in the number of taxable income brackets from 13 to six effective January 1988
- Cuts in marginal tax rates as of January 1988, with the minimum rate (taxable income of ¥1.2 million or less) going to 10 percent and the maximum rate (taxable income over ¥15 million) dropping to 50 percent
- Deduction of ¥150,000 in spousal taxable income for a married couple with a taxable income of less than ¥8 million

Corporate Income Taxes

- Reduction of the basic tax rate for retained earnings to 40 percent
- Increase in the basic tax rate for distributed earnings to 35 percent

Local Taxes

Personal Income Taxes

- Reduction in the number of prefectural and municipal taxable income brackets to four
- Cuts in marginal tax rates above the minimum 5 percent rate, with a top rate of 15 percent
- Deduction of ¥120,000 of spousal taxable income

Proposed Tax Cuts for FY 1989

National Taxes

Corporate Income Taxes

- Reduction of the basic tax rate for retained earnings to 37.5 percent
- Increase in the basic tax rate for distributed earnings to 37.5 percent

Despite these exclusions, the four major opposition parties have come down hard on the LDP, accusing Prime Minister Yasuhiro Nakasone of violating his July 1986 campaign pledge not to back the introduction of a major new indirect tax. Even some members of the premier's own party are said to oppose the sales tax plan. Business leaders can be expected to fan this opposition since they are convinced that many if not most companies will have trouble passing on the full tax in the form of higher prices.

An equally controversial proposal to reform Japan's much-abused small savings system effective October 1, 1987 has also produced a backlash. According to the LDP tax council plan, the tax-exempt status of interest income earned on postal savings and bank accounts of up to Y3 million ($18,750) will be eliminated for all taxpayers except senior citizens, handicapped people and single-parent families, replaced by a 20 percent withholding tax. The nontaxable status of interest income from several other sources will also be changed this October if the party panel has its way.

Susan MacKnight

Special Diet Session Wraps Up; Regular Session Convenes

The extraordinary session of the Diet, which concluded December 20, was quickly followed by the convocation of the regular 150-day session December 29. The special session may be long remembered for its enactment of legislation reorganizing the Japanese National Railways as a group of private systems, the last measure in a series of steps to privatize quasi-government corporations and thereby reduce government spending. Among the 24 bills approved during the session was a measure increasing costs to individuals covered by the national health insurance program, another item directed at containing government expenditures.

The 101-day extraordinary session was held in accordance with the constitutional requirement that such a session follow the dissolution of the Diet and subsequent elections. The July 1986 double elections resulted in the largest majority for the ruling Liberal Democratic Party in its 30-year history, a stunning victory for Prime Minister Yasuhiro Nakasone. The momentum established by the electoral victory carried over into the extraordinary session and provided the impetus necessary to secure approval of the JNR reorganization bill, by far the most controversial and sensitive of the major administrative reform measures approved by the government over the last two years. (Previous bills privatized the organizations that monopolized the domestic markets for telecommunications equipment and services and tobacco products.)

The new Diet will reconvene January 26 to face a series of tough choices on the budget for the year starting April 1. Increased defense spending will rank among the most difficult issues, particularly in light of the fact that total spending will exceed the 10-year-old limit of 1 percent of the country's gross national product. The Diet will also have to grapple with tax reform (see articles in this issue).

The new session may also consider controversial proposals to institute anti-espionage laws. The Nakasone government reportedly had hoped to introduce

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VOTING PATTERNS ON TRADE ISSUES IN THE 99TH CONGRESS

Summary

Voting patterns on trade legislation in the 99th Congress reveal that certain factors are related to legislators' strategies vis-a-vis trade issues. These factors -- partisanship, whether the legislator takes a liberal or conservative view toward other economic issues, and the geographic region he or she represents -- can be used to predict lawmakers' likely positions on trade issues. By contrast, some factors that might be expected to relate to trade votes show little or no correlation. This report will provide a breakdown of the variables that are related to voting on trade matters as well as discuss the patterns that can be detected in the votes of the last Congress.

Introduction

As the members of the 100th Congress gear up to consider trade legislation, it may be useful to look at the trade-related voting patterns of the 99th Congress. Given the complexity of the issues, it is impossible to state definitively what factors persuade lawmakers to vote for or against a specific bill. Yet it is possible to identify the trends associated with trade votes.

This report examines the roll call votes on trade issues in the House and Senate during the 99th Congress. Nine House votes and eight Senate votes were analyzed (see Appendix 1). Depending on the results of this tally, each legislator was assigned a trade score that indicated his or her tendency to vote for legislation that would, at least in the short run, restrict the flow of goods and services between countries. Scores ranged from 0 to 100. A legislator given a high score would be one who voted relatively often to restrict trade flows. Conversely, one whose score was low would tend to vote in such a way as to maintain (at least in the short run) the present international flow of goods and services.

It should be stressed that this analysis does not address the long-term goals and strategies of legislators. That is, an individual may support legislation that imposes trade restrictions -- such as reciprocity requirements -- because he or she believes their long-term effect will be to enhance international trade. For the purposes of this study, votes were categorized as "restricting" or "maintaining" the flow of international goods and services strictly according to the short-term effect they would have on trade. Note that neither term is used pejoratively; this report analyzes differences in legislative strategies, not intentions or beliefs.

As shown in Figures 1 and 2, there were two distinct clusters of trade scores in both chambers of Congress. This bimodal distribution indicates that one group of legislators voted fairly consistently for legislation that would restrict the flow of trade, while the other voted against it. In order to determine what characteristics distinguish these two groups, the trade scores of the legislators were analyzed, as were the votes on the House omnibus trade bill (HR 4800), House and Senate votes on textile and apparel quotas (HR 1562), and the House vote to override the presidential veto of HR 1562. In each case the votes were examined to see if they were correlated with: (1) partisanship; (2) liberal/conservative attitude toward economic issues [L/C attitude]; (3) geographic region represented; (4) odds favoring election in 1986; (5) seniority; (6) age; and (7) membership on key trade committees.

Overall Results -- Predictive Value of Variables

If there is a correlation between the variables listed above and the outcome of trade votes, we should be able to use those variables to predict an individual legislator's likely trade score or specific votes. As seen in Table 1, the predictor variables functioned most effectively for the House trade scores and HR 4800. Throughout the rest of this report it will be useful to remember that while the variable set helped to predict the Senate trade scores, the veto override and the vote on HR 1562, the multiple correlations were only moderately high.

Table 1: Correlations Between Trade Votes and the Set of Predictors
(Multiple Correlations)

	House	Senate
Trade scores	0.80	0.54
HR 1562	0.53	0.65
HR 4800	0.74	--
Veto override	0.54	--

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Figure 1: Trade Score Distributions, House of Representatives

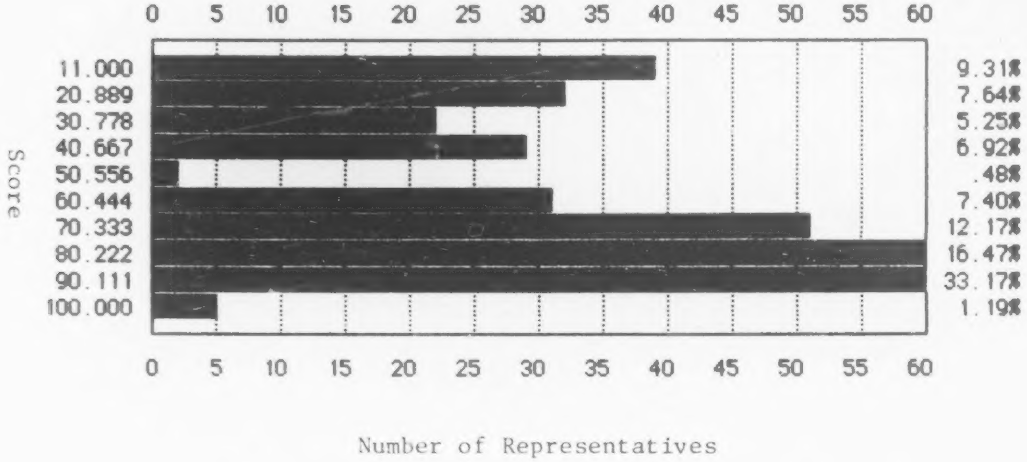
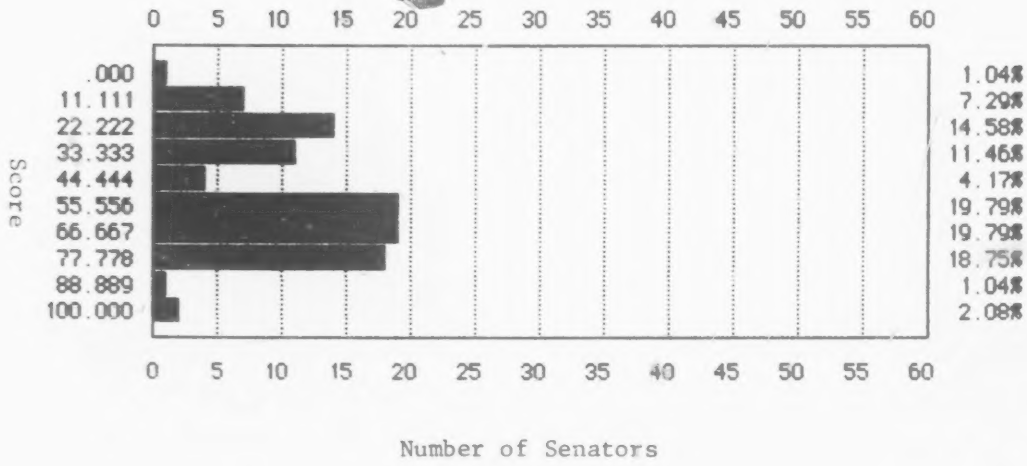


Figure 2: Trade Score Distributions, Senate



Furthermore, certain variables are more relevant to voting patterns than others. Only three of the seven variables examined were important in predicting trade votes: partisanship, L/C attitude and region. Thus, even if 1986 election odds, seniority, age and committee membership are dropped from the analysis, almost no predictive value is lost -- in other words, the multiple correlations remain almost exactly the same.

Partisanship

Is trade a partisan issue? On the one hand, legislators often deny that the issue is at all partisan. Yet certainly it pervades congressional rhetoric. For example, one month prior to the mid-term elections, the House Democratic Trade Task Force, including now-Speaker of the House Jim Wright, (D, Tex.), publicly urged "the President and the President's Republican-led Senate to take action on trade." Therefore, the question is not trivial; nor is the answer obvious.

Few would claim that trade votes are strictly partisan. A quick glance reveals that members of both parties vote for and against trade legislation. However, House Democrats were visibly more likely than Republicans to support the three bills included in this study -- each of which would have restricted trade flows. Democratic senators were also more likely to vote for textile and apparel quotas than were their Republican counterparts (see Figure 3).

Moreover, the Democrats voted more consistently as a group. Although the majority of Republicans voted against each of the bills listed above, there was a considerable amount of variability among GOP legislators. Nonetheless, partisanship was clearly a factor associated with trade votes. Statistical analysis showed a moderately strong correlation between party membership and legislators' votes. This can be seen in Table 2, which combines the votes of members of both parties.

Table 2: Correlations Between Partisanship and Trade Votes

	House	Senate
Trade scores	0.73	0.34
HR 1562	0.31	0.31
HR 4800	0.70	--
Veto override	0.42	--

The most partisan vote was that on the omnibus trade bill, HR 4800. With regard to trade scores, partisanship was stronger in the House than in the Senate. This is not surprising because several of the votes that were used to calculate House members' trade scores were votes on proposed amendments to HR 4800. By the time the House voted on these amendments during the final days of the debate, the trade issue had become highly visible and politicized. Since the White House opposed the bill, a number of amendments were introduced to make the package more palatable to the administration. Republicans were faced with the choice of whether or not to support administration policy not only on the bill itself but also on those amendments. In this respect, the importance

Figure 3: Breakdown of Trade Votes by Party

House of Representatives

HR 4800

	YES	NO
Dem.	234 57.5%	4 1.0%
Rep.	58 14.3%	111 27.3%

(Actual vote: 295-115)

HR 1562

	YES	NO
Dem.	183 44.7%	60 14.7%
Rep.	74 18.1%	92 22.5%

(Actual vote: 262-159)

Override

	YES	NO
Dem.	199 48.2%	42 10.2%
Rep.	72 17.4%	100 24.2%

(Actual vote: 276-149)

Senate

HR 1562

	YES	NO
Dem.	35 36.8%	10 10.5%
Rep.	24 25.3%	26 27.4%

(Actual vote: 60-39)

Note: Because of some missing predictor variables, certain cases were dropped from the analysis. Consequently, the sum of the votes in tables throughout this report may not equal official vote tallies.

of party allegiance may not just reflect differences in the parties' trade attitudes; it may also indicate differences in the political considerations each faces vis-a-vis the White House.

On the Senate side, the votes that comprised the trade scores generally addressed several industries -- for example, textiles, oil and agriculture. Moreover, nearly all these bills were considered within the context of other issues, not just trade. This may help to explain the fact that while partisanship was associated with Senate voting, its predictive value was not as strong as it was for the House.

The House and Senate votes on the textile-apparel bill and the override attempt were also politicized, and partisanship was moderately correlated with the vote outcomes. Since the measure concerned a sectoral issue, however, other factors were more strongly associated with the voting patterns.

Liberal/Conservative Attitude

In this report the scores measuring liberal or conservative attitude with regard to other economic issues were based on a National Journal analysis published May 17, 1986. In both the House and the Senate, those lawmakers who voted conservatively on other economic issues tended to support measures that maintained the present level of trade, while those who were liberal on economic issues outside the trade field were more likely to vote for restrictions (see Table 3).

Table 3: Correlations Between Liberal/Conservative Attitude and Trade Votes

	House	Senate
Trade scores	0.72	0.36
HR 1562	0.33	0.30
HR 4800	0.65	--
Veto override	0.41	--

Thus, both party affiliation and the legislator's L/C attitude are useful in predicting his or her votes on trade issues. But because these variables are themselves highly correlated (approximate correlation of 0.8), it is difficult to determine which is more highly associated with trade votes. In other words, the two factors are largely interchangeable as predictors. Nonetheless, since using both variables to predict trade votes produced better results than using only one, it is safe to conclude that each has a unique relationship with trade votes.

Partisanship and L/C attitude were by far the most important variables in predicting House trade scores and votes on HR 4800. If they are dropped from the analysis, 90 percent of the total predictability (R^2) for the House trade scores is lost, as is 86 percent of the predictability for the vote on HR 4800. On the other side of Capitol Hill, these variables were not as decisive for the trade scores, constituting some 27 percent of total predictability.

Similarly, while partisanship and L/C attitude were related to votes on the textile bill, they were not the most important predictors. They made up 46 percent of the predictability of the House votes on HR 1562 and 9 percent of the predictability of the Senate votes on that bill. With regard to the House attempt to override the veto of HR 1562 -- a highly politicized move -- partisanship and L/C attitude were the most important predictors, accounting for a full 61 percent of total predictability.

Region

For the purposes of the analysis, the United States was divided into four regions: Northwest, Central/Southwest, Southeast and Northeast (see Appendix 2). Correlations with trade votes varied from low to moderate, depending on the region (see Table 4).

Table 4: Correlations Between Region and Trade Votes

House of Representatives

	Northwest	Central/ Southwest	Southeast	Northeast
Trade scores	-0.20	-0.12	0.12	0.15
HR 4800	-0.16	-0.01	0.05	0.09
HR 1562	-0.31	-0.12	0.22	0.16
Veto override	-0.31	-0.04	0.17	0.14

Senate

	Northwest	Central/ Southwest	Southeast	Northeast
Trade scores	-0.35	-0.10	0.27	0.18
HR 1562	-0.34	-0.32	0.38	0.28

While several of these correlations are small, it is interesting to note that the *direction* of the correlation is consistent in all cases. That is, the negative correlations in the Northwest and Central/Southwest indicate a tendency (albeit slight in some cases) to vote against new restrictions. By contrast, legislators from the Southeast and Northeast were more likely to vote for legislation that would restrict trade flows. (Note that the correlations for the votes on HR 4800 are probably too low to indicate any significant trend.) The regional pattern by actual voting frequencies is shown in Figure 4.

It should come as no surprise that Southeastern legislators tended to support trade restrictions on textile and apparel imports. In this respect the results of the analysis support the conventional wisdom that a lawmaker's first priority is to represent the interests of his or her constituents. Perhaps we

Figure 4: Breakdown of Trade Votes by Region

HR 4800

	YES	NO
NW	43 10.6%	33 8.1%
C/SW	52 12.8%	21 5.2%
SE	64 15.7%	20 4.9%
NE	133 32.7%	41 10.1%

(Actual vote: 295-115)

Override

	YES	NO
NW	28 6.8%	51 12.3%
C/SW	45 10.9%	28 6.8%
SE	69 16.7%	16 3.9%
NE	129 31.2%	47 11.4%

(Actual vote: 276-149)

House: HR 1562

	YES	NO
NW	25 6.1%	53 13.0%
C/SW	37 9.0%	37 9.0%
SE	72 17.6%	14 3.4%
NE	123 30.1%	48 11.7%

(Actual vote: 262-159)

Senate: HR 1562

	YES	NO
NW	8 8.4%	16 16.8%
C/SW	7 7.4%	14 14.7%
SE	18 18.9%	0 0.0%
NE	26 27.4%	6 6.3%

(Actual vote: 60-39)

should also expect legislators from regions with little interest in the textile and apparel industries to oppose HR 1562 -- thus, the negative correlations for the Northwest and Central/Southwest. However, the pattern found in the Northeast, where there are few textile-apparel plants, is somewhat of a break with conventional wisdom since legislators from that area also tended to vote for restrictions on textile-apparel imports. Why this should be so is, of course, not inherent in the data. It may be that because the Northeast has its own share of aging industries -- many of which are suffering from import competition -- lawmakers are sensitive to the problems of the textile and apparel industries.

It should also be noted that the regional correlations for the trade scores were highly dependent on the types of votes comprising the scores (see Appendix 1). The votes included in the Senate trade scores, for example, contained no sectoral issue that was of strong interest to the Northwest. This may account for the moderately strong negative correlation for that region. If sectoral issues more pertinent to the area's interests had been brought to a vote, the correlations might have been different.

In general, region is a more important variable in predicting the votes on textiles and apparel -- a specific sectoral issue -- than the overall trade score, which included votes on several issues. In particular, region accounted for 52 percent of the predictability of the House votes on HR 1562 and 33 percent of the override attempt votes, but just 8 percent of the House trade scores and 2 percent of HR 4800. Similarly, region represented 57 percent of the predictability of the Senate votes on HR 1562, with the margin falling to 35 percent of the Senate trade scores. Again, it is important to remember that the total predictability of some of these votes is only moderate.

Election Odds in 1986

All legislators face two (not always compatible) issues: how to support legislation that is good for the United States and how to get re-elected. The short two-year term of a representative means that re-election is a constant concern; the senator's six-year tenure allows a respite from active campaigning but also requires him or her to keep one eye on upcoming elections. Thus, it is not unreasonable to expect a legislator whose seat is secure to approach trade votes with a different attitude than one whose position is vulnerable. This was not the case in the 99th Congress, where the correlations between votes and election odds (as measured) ranged from 0.00 to 0.16 -- all extremely low.

It can be concluded that, at least during the 99th Congress, those legislators who faced tough 1986 campaigns did not display a markedly different attitude towards trade votes than those who were not up for re-election or were running in a safe district. This is compatible with the fact that few legislators who ran for re-election stressed trade in their campaigns. They either focused on narrower issues that were important to their constituents or settled for running a non-issue, media-oriented campaign. Thus, while it is true that the Democratic Party as a whole made some effort to highlight trade as a campaign issue, this analysis indicates that upcoming elections were not related to an individual legislator's decisions on trade-related votes.

Age and Seniority

Two other variables included in the analysis were age and seniority at the beginning of the 99th Congress. While these factors are not often discussed in connection with voting on trade issues, they were included here in order to determine if the votes of older legislators and those who have seen more years in Congress (and by extension, more trade debates) differed from the younger and newer members. The correlations between a lawmaker's age and his or her votes on trade issues ran from 0.03 to 0.10, while those reflecting seniority were a little higher, ranging from 0.05 to 0.19. As these low correlations indicate, the two variables have little or no predictive value with regard to the outcome of trade votes.

Membership on Trade Committees

A final variable in this analysis was membership on the House Ways and Means Committee and the Senate Finance Committee. Since the members of these committees spend much of their time considering trade issues and marking up legislation before it is introduced to the full chamber, it was hypothesized that they may develop voting strategies that differ from non-members.

On the House side, no relationship was determined. Correlations were extremely low, running from 0.02 to 0.05. Thus, it is safe to say that Ways and Means Committee members in the 99th Congress did not vote in a markedly different manner than other representatives. In the Senate, however, there was a moderately weak relationship between Finance Committee membership and trade votes. The correlation between membership and the trade scores was 0.20, while for the Senate votes on HR 1562 it was 0.24. In other words, members of the Senate Finance Committee displayed a slightly higher tendency to vote against trade restrictions than did non-members.

This relationship may be somewhat misleading. Membership on the Finance Committee was also correlated with region because a disproportionate number of members were from the Northwest or Central/Southwest. No less than 14 of the committee's 20 members represented one of these two regions, whose lawmakers, as noted earlier, tended to vote against trade restrictions. Therefore, the correlation could be due more to the regional make-up of the committee than an inherent characteristic of the committee. This possibility is made more likely by the fact that when all variables -- including region -- were used to predict vote outcomes, the committee membership variable adds only 1 percentage point to the predictability of the Senate votes on HR 1562 and 3 percent for the Senate trade scores.

Predicting Votes With Votes

Thus far it has been established that among the variables used in this analysis, partisanship, liberal/conservative attitude and region were the only three factors highly associated with votes on trade issues in the last Congress. It was also shown in Table 1 that the combination of these variables will predict the House trade scores and the votes on HR 4800 with more accuracy than any of the other votes.

Another method of predicting the outcome of individual House votes may be just as effective, however. Using the votes on HR 1562, HR 4800 and the override attempt on HR 1562, Figure 5 demonstrates that a representative who

Figure 5: Relationship Among House Votes on HR 4800, HR 1562 and Override

		HR 4800	
		YES	NO
Override	YES	240 59.9%	24 6.0%
	NO	47 11.7%	90 22.4%

		HR 4800	
		YES	NO
HR 1562	YES	222 55.9%	27 6.8%
	NO	68 17.1%	80 20.2%

		Override	
		YES	NO
HR 1562	YES	246 60.9%	9 2.2%
	NO	23 5.7%	126 31.2%

voted for one of these bills was more likely to support the others, while someone who voted against one was likely to vote against the others as well.

For example, predicting the vote to override the veto of HR 1562 by using the votes on two previous trade bills -- HR 1562 and HR 4800 -- can be done with a fair amount of accuracy. The correlation of the override vote and the pair of predictor votes is 0.66. Thus, the analysis demonstrates what instinct might lead us to believe -- that a legislator who voted to restrict trade once is more likely to vote that way again than someone who has voted against such restrictions.

Implications for the 100th Congress

Since none of the bills discussed in this report became law, many legislators are devising strategies to bring similar legislation to the floor during the 100th Congress. If the major issues remain the same, it is not unreasonable to assume that the regional voting patterns described earlier will remain unchanged. That is, we can expect to see legislators who represent areas in which struggling industries are located (the Northeast and Southeast) to continue to vote to restrict certain imports (at least in the short run). If, however, other sectoral issues are added to the congressional debate, geographic voting patterns may shift. For example, if more legislation concerning timber and softwood lumber is considered during this Congress, the negative correlations associated with the Northwest may do a 180-degree turnaround.

What will be more interesting to watch during the 100th Congress is partisanship. As mentioned earlier, political considerations exogenous to trade issues almost certainly influenced certain votes during the last Congress. Many House Republicans, knowing that the president opposed HR 4800, demonstrated their support for the administration by voting against such legislation. This year, however, the White House has indicated that it intends to cooperate with Congress in formulating trade legislation. It remains to be seen if this will lower the importance of partisanship in predicting the votes of the 100th Congress -- especially in view of the Iran-contra affair, which is likely to weaken the administration's influence in Congress. Conversely, partisanship may remain strong, in which case the question may be what type of trade bill will legislators support, instead of whether or not they vote for restrictive trade legislation.

For further information, or to obtain a more detailed explanation of the methodology used in the analysis, contact Eileen Marie Doherty.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix 1: Votes Used in Analysis

House of Representatives - 99th Congress

1. HR 4800 (Vote, 5/22/86) - An omnibus trade bill, including sections to broaden the range of foreign trade practices considered actionable; require the president to act more quickly on trade problems; expand the types of retaliatory measures; tighten presidential discretion; and mandate reductions in bilateral imbalances for countries with excessive surpluses that display a pattern of unfair trade practices.

"YES" vote = restrict flow of goods and services
"NO" vote = maintain flow of goods and services

2. Roth amendment to HR 4800 (Vote, 5/21/86) - An amendment to eliminate from HR 4800 provisions that loosened export control requirements for goods affecting national security.

"YES" vote = restrict flow of goods and services
"NO" vote = maintain flow of goods and services

3. Frenzel amendment #2 to HR 4800 (Vote, 5/21/86) - An amendment to eliminate from HR 4800 provisions that tightened antidumping and countervailing-duty laws.

"NO" vote = restrict flow of goods and services
"YES" vote = maintain flow of goods and services

4. Bonker amendment to HR 4800 (Vote, 5/21/86) - An amendment to remove the $300 million authorization for a mixed credit "war chest" and allow the Agency for International Development's Economic Support Fund to be used for U.S. mixed credit offerings.

"NO" vote = restrict flow of goods and services
"YES" vote = maintain flow of goods and services

5. Crane amendment to HR 4800 (Vote, 5/21/86) - An amendment to loosen provisions in HR 4800 concerning Section 301 cases. It would also strike the Gephardt amendment (mandatory reductions of trade surpluses for countries whose surpluses are deemed "excessive").

"NO" vote = restrict flow of goods and services
"YES" vote = maintain flow of goods and services

6. Michel amendment to HR 4800 (Vote, 5/22/86) - An amendment offered as an alternative to HR 4800. Among other things it would remove a provision permitting injured U.S. industries to collect damages; strike the $1 billion authorization for adjustment assistance; not identify export targeting, resource subsidies and violations of international worker rights as unfair trade practices; and eliminate the Gephardt amendment.

"NO" vote = restrict flow of goods and services
"YES" vote = maintain flow of goods and services

7. HR 1562 - Original House passage (Vote, 10/10/85) - A bill to limit imports of textiles and apparel from certain countries.

   "YES" vote = restrict flow of goods and services
   "NO" vote = maintain flow of goods and services

8. HR 1562 - Override attempt (Vote, 8/6/86) - An attempt to override the president's veto.

   "YES" vote = restrict flow of goods and services
   "NO" vote = maintain flow of goods and services

9. English amendment (substitute for Smith amendment) to HR 2100 (Vote, 10/3/85) - An amendment to exempt agricultural goods from the requirement that exports be shipped on U.S. bottoms.

   "NO" vote = restrict flow of goods and services
   "YES" vote = maintain flow of goods and services

Senate - 99th Congress

1. Amendment No. 611 to S 1200 (Vote, 9/17/85) - An amendment calling for a tariff of 60 cents a gallon on imported ethanol.

   "YES" vote = restrict flow of goods and services
   "NO" vote = maintain flow of goods and services

2. Thurmond amendment to SJ Res 77 (Vote to Table, 10/2/85) - An amendment to restrict textile, apparel and footwear imports.

   "NO" vote = restrict flow of goods and services
   "YES" vote = maintain flow of goods and services

3. Hollings amendment to S 1730 (Vote to Table, 10/24/85) - An amendment to impose quantitative restrictions on textile, apparel and footwear imports.

   "NO" vote = restrict flow of goods and services
   "YES" vote = maintain flow of goods and services

4. Symms amendment to S 1714 (Vote, 10/25/85) - An amendment to require U.S. representatives to international financial institutions to oppose assistance by such institutions for the production of agricultural commodities that compete with commodities produced in the United States.

   "YES" vote = restrict flow of goods and services
   "NO" vote = maintain flow of goods and services

5. Cochran amendment to S 1714 (Vote, 10/29/85) - An amendment to exempt Department of Agriculture "commercial-type export programs" from the requirement that exports be shipped on U.S. bottoms.

   "NO" vote = restrict flow of goods and services
   "YES" vote = maintain flow of goods and services

6. HR 1562 (Vote, 11/13/85) - A bill to impose quantitative restrictions on textile, apparel and footwear imports and directing the president to negotiate voluntary restraint agreements covering copper with other countries.

   "YES" vote = restrict flow of goods and services
   "NO" vote = maintain flow of goods and services

7. Hart amendment to SJ Res 77 (Vote to Table, 11/14/85) - An amendment to increase the tariff on petroleum and petroleum products by $10 a barrel.

   "NO" vote = restrict flow of goods and services
   "YES" vote = maintain flow of goods and services

8. Hart amendment to HJ Res 668 (Vote to Table, 7/31/86) - An amendment to increase the tariff on petroleum and petroleum products by $10 per barrel.

   "NO" vote = restrict flow of goods and services
   "YES" vote = maintain flow of goods and services

Appendix 2: States Listed by Region

Northwest - Washington, Oregon, California, Alaska, Hawaii, Montana, Idaho, Wyoming, Colorado, New Mexico, Arizona, Utah and Nevada.

Central/Southwest - Minnesota, Iowa, Missouri, North Dakota, South Dakota, Nebraska, Kansas, Arkansas, Louisiana, Oklahoma and Texas.

Southeast - Kentucky, Tennessee, Alabama, Mississippi, Virginia, West Virginia, North Carolina, South Carolina, Georgia and Florida.

Northeast - Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania, Delaware, Maryland, Ohio, Indiana, Illinois, Michigan and Wisconsin.

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FY 1987 Economic Outlook

The Japanese government's economic outlook, adopted by the cabinet December 24, forecasts 3.5 percent inflation-adjusted growth for FY 1987 (April 1, 1987-March 31, 1988), despite the adverse effects of the strong yen. This figure represents a small acceleration of the revised 3 percent rate estimated for the current fiscal year (see Table 1). Economic officials believe moderately high growth is essential to reduce the country's trade surplus and encourage a shift to domestic demand-led growth.

While the move to lower the original FY 1986 outlook of 4 percent real growth, which was based on an exchange rate of Y204=$1.00, had been anticipated, the new estimate is substantially higher than the 2.1 percent growth projected by private-sector economists (see Table 2). This pessimism reflects the drop in economic growth from 3.8 percent at an annual rate in the April-June 1986 quarter to 2.6 percent in the July-September period, as exports fell 4.1 percent while imports climbed 3.2 percent.

Table 1: Japanese Government's FY 1987 Forecast

(percentage change in real terms)

	Actual			Estimated	Projected
	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987
Gross National Product	3.7%	5.1%	4.3%	3.0%	3.5%
Consumer Spending	3.0	2.6	2.6	3.7	3.4
Residential Construction	-8.9	0.5	2.9	12.7	7.1
Private Capital Spending	4.9	11.4	12.9	5.2	6.6
Current Account Surplus*	$24.2	$37.0	$55.0	$88.0	$77.0
Trade Surplus*	$34.5	$45.6	$61.6	$94.0	$81.0
Wholesale Prices	-2.3	0.2	-2.9	-9.7	1.0
Consumer Prices	1.9	2.2	1.9	0.5	1.6

*In billions of dollars.

Finance Minister Kiichi Miyazawa said that the economy will bottom out in the latter half of 1987 if effective government policies are pursued. Tokyo is counting on domestic demand to boost the economy by 4 percent in FY 1987 and offset the external sector's 0.5 percent negative impact. The outlook calls for a 3.4 percent increase in consumer spending, which would be the largest since FY 1982. Residential construction and private capital spending are expected to remain strong, increasing 7.1 percent and 6.6 percent, respectively. Mining and manufacturing production is expected to reverse this year's decline with a 2.2 percent rise in FY 1987, which should keep unemployment under 3 percent.

The government's outlook for the coming fiscal year assumes that the exchange rate will remain stable at Y163=$1.00. Tokyo expects the 60 percent appreciation of the yen since February 1985 to produce a modest decline in its trade and current account surpluses, reversing four consecutive annual increases. The outlook's $77 billion current account surplus in FY 1987 would be equivalent to about 3.6 percent of nominal gross national product, down from an estimated 4.3 percent in the year ending in March 1987.

Private-sector economists forecast FY 1987 real growth in the 1.6 percent to 3.5 percent range, with an average of 2.4 percent. The Research Institute of the National Economy, which agrees with the government's figures, expects record low interest rates, increased government spending under the Fiscal Investment and Loan Program, and improved terms of trade to boost the economy. Continued low inflation, it forecasts, will increase real income and encourage consumer spending, while investment remains strong in the nonmanufacturing sector.

Table 2: Summary of Private Forecasts

(percentage change in real terms)

	GNP FY 1986	GNP FY 1987	Current Account Surplus*	Y/$ Exchange Rate	Oil Price ($/barrel)
Banks					
Hokkaido Takushoku Bank	1.8%	2.1%	$74.3	Y170.5	$15.1
Fuji Bank	2.0	1.7	70.0	161.0	17.5
Taiyo Kobe Bank	2.0	2.5	84.6	162.5	14.5
Sumitomo Trust	2.1	3.0	76.8	160.0	15.1
Mitsubishi Trust	2.1	2.4	75.7	157.0	15.6
Bank of Yokohama	2.1	1.9	65.6	160.0	15.0
Dai-Ichi Kangyo Bank	2.2	2.6	88.5	150.0	15.0
Nippon Credit Bank	2.2	2.7	72.5	157.5	16.5
Yasuda Trust	2.2	1.9	86.1	160.0	15.5
Bank of Tokyo	2.3	2.7	72.2	153.5	15.6
Mitsui Trust	2.3	1.9	70.4	154.3	15.0
Tokai Bank	2.4	1.6	80.0	150.0	15.0
Insurance Companies					
Asahi Mutual Life	1.9	2.6	96.5	159.0	15.5
Tokio Marine	2.1	2.5	71.2	163.0	15.6
Meiji Mutual Life	2.3	2.4	75.6	157.5	15.0
Nippon Life	2.4	2.3	88.0	160.0	17.0
Research Organizations					
Mitsubishi Research Institute	1.9	1.8	86.8	163.0	16.0
Okasan Economic Research Institute	2.1	2.3	87.1	152.5	15.0
Kangyo Kakumaru Research Institute	2.1	3.0	82.6	165.0	16.0
Nomura Research Institute	2.2	2.3	73.5	152.0	13.0
Cosmo Research Center	2.3	2.7	73.9	160.0	14.8
Japan Economic Research Center	2.3	3.1	85.7	151.3	15.9
Nikko Research Center	2.4	2.7	73.9	161.5	16.0
Sanwa Research Institute	2.5	2.5	73.1	158.0	15.0
Research Institue of the National Economy	2.5	3.5	81.3	155.0	14.8
Average	2.1	2.4	78.6	158.1	15.4

*In billions of dollars.

Most economists, though, expect the effect of the strong yen to keep growth under 3 percent in FY 1987. According to Nomura Research Institute, for example, export volume will drop 4.2 percent, reducing corporate profits and limiting wage increases. This, in turn, will have a negative effect on business investment and consumer spending. As a result of slower growth, Sanwa Research Institute expects unemployment to reach a record 3.5 percent by the end of FY 1987.

Randall S. Jones

Currency Realignment In 1986

Last year was a turbulent period in foreign exchange markets, marked by a continuation of the yen's appreciation against the dollar that began in March 1985. The yen's rise during the first eight months of 1986 increased its average annual value to Y168.5=$1.00 (see Table 1). Although it remained relatively stable during the last few months of the year, by yearend there were signs that the Japanese currency was poised for further gains.

Table 1: Yen-Dollar Exchange Rate, 1981-86

(monthly average)

	1981	1982	1983	1984	1985	1986
January	Y202.0	Y224.6	Y232.9	Y234.0	Y254.1	Y200.0
February	205.9	235.2	236.3	233.7	260.3	184.6
March	208.8	240.7	237.9	225.5	258.4	178.8
April	215.1	244.9	237.7	225.0	251.7	175.6
May	220.7	236.5	234.8	230.7	251.6	166.9
June	224.2	251.0	240.1	233.3	249.0	167.8
July	232.0	255.1	240.5	242.7	241.7	158.7
August	233.7	258.8	244.4	242.2	237.2	154.1
September	230.0	262.7	242.7	245.2	236.9	154.8
October	231.4	271.4	233.0	246.9	214.8	156.0
November	223.7	265.1	235.3	243.3	203.9	162.7
December	218.8	242.5	234.3	248.0	202.8	162.1
Annual Average	220.5	249.1	237.5	237.5	238.5	168.5

Following former Finance Minister Noboru Takeshita's statement in January 1986 that Japanese industry could live with an exchange rate of Y190=$1.00, the yen began a sustained rise. Worried about the impact on its economy, Tokyo attempted to stabilize exchange rates through market intervention and official discount rate cuts at the end of January and again in early March and late April. But the yen, aided by falling oil prices and the sluggish U.S. economy, continued rising to a postwar record high of Y152.55 on August 20, 72.8 percent above its February 13, 1985 trough and 58.6 percent higher than its value prior to the September 22, 1985 Group of Five meeting.

Having seen that a weaker dollar alone was not going to significantly reduce the huge U.S. trade deficit, Reagan administration economic officials last fall began to shift their emphasis to encouraging faster economic growth in major trading partners. Moreover, Federal Reserve Board chairman Paul Volcker warned in late September that a further decline in the dollar could be counterproductive. In addition, an apparent improvement in U.S. trade figures contributed to a small rise in the dollar. The yen-dollar exchange rate remained in the Y160-Y165 zone, following an October 31 agreement between Treasury Secretary James Baker and Finance Minister Kiichi Miyazawa stating that currency values were consistent with economic fundamentals (see JEI Report No. 41B, November 7, 1986).

Although not as dramatically, the yen also appreciated against the European Currency Unit in 1986 (see Table 2). This trend was reversed during the last few months of the year, however, in the wake of the Baker-Miyazawa accord. On December 31 the yen was down 6 to 8 percent from September levels against the Deutsche mark, Swiss franc and French franc.

Table 2: Yen-ECU Exchange Rate, 1981-86

(monthly average)

	1981	1982	1983	1984	1985	1986
January	Y259.8	Y239.6	Y224.0	Y188.1	Y178.3	Y178.4
February	248.4	242.9	223.1	194.1	175.9	171.1
March	251.8	243.8	223.2	193.9	174.2	170.4
April	252.6	244.5	219.9	190.2	182.3	166.1
May	244.3	244.4	215.7	187.9	181.2	161.0
June	239.0	245.5	214.3	190.3	182.4	161.3
July	239.8	244.5	211.4	190.7	186.3	157.1
August	235.3	246.4	208.3	187.9	189.3	157.4
September	243.1	247.3	206.7	181.8	185.5	159.0
October	251.3	252.5	201.8	179.7	179.6	n.a.
November	245.7	242.7	198.5	181.5	173.8	n.a.
December	237.1	231.5	192.6	178.3	177.0	n.a.
Annual Average	245.4	243.6	211.4	187.1	180.6	n.a.

This brief period of stability in the yen-dollar exchange rate ended as the yen passed the Y160 level at the end of December and continued rising in January despite intervention by the Bank of Japan. The yen rose to Y153.8 on January 14, its highest level since October 7, because of concern over the health of the U.S. economy and the announcement of a record $19.2 billion November trade deficit, which dashed hopes that the deficit had finally bottomed out. The appreciation of the German mark against the dollar put upward pressure on the yen as well.

The Japanese government has promised to do all it can to prevent a further rise in the yen. Bank of Japan governor Satoshi Sumita said January 14 that exchange rate stability is the key to the recovery of Japan's economy.

And Mr. Miyazawa, who has stated that Y170=$1.00 is the appropriate exchange rate, has promised vigorous efforts to stabilize the yen. But although Tokyo had a record $42.2 billion in foreign exchange reserves at the end of 1986, intervention has little chance of reversing trends in the $150 billion-a-day currency market.

Morgan Guaranty Trust Co. reports that although the dollar has fallen 20 percent since 1985's peak, it is still more than 15 percent above its 1980 level. Given the huge U.S. trade deficit and the sluggish economy, there is likely to be more downward pressure on the dollar in 1987. Many experts describe the dollar's sharp plunge during the past week as a free fall. Although Tokyo says that the Baker-Miyazawa accord is still in effect, Washington so far has made no move to defend the dollar. The yen is likely, therefore, to remain strong and even appreciate to new record highs in 1987.

Randall S. Jones

Education Reports: The Grass Is Greener . . .

The United States and Japan recently released reports comparing the two countries' education systems, finding much to praise and lament on both sides. Despite the efforts at evenhandedness, the overall impression is that once again the United States can learn from its Pacific partner in still another field.

Few observations contained in either of the reports surprised those who have been following the education reform debates in this country or Japan. The U.S. study praised the society-wide dedication to education in Japan; the high regard in which teachers are held (and their generally high pay scales compared with other white-collar careers); the emphasis on fundamentals; and the overall high achievement levels among students. In commenting on the study's results, however, Education Secretary William Bennett also noted the well-known disadvantages accompanying education in Japan, including the lack of attention to individual needs of students -- particularly the gifted -- and the examination pressures that follow students throughout their academic careers.

The Japanese report restricted itself to general observations on the reform movement in the United States and a broad description of education in this country. The second part of the study is due later this year, which observers hope will contain more analysis of the problems and pluses of the educational system in this country.

The studies are the result of a 1983 agreement by President Reagan and Prime Minister Yasuhiro Nakasone to address the issue in the spirit of a bilateral learning experience. While Americans may have tired of hearing how much they can learn from Japan, the U.S. report nevertheless suggests that there is much that educators can import from Japan. At the very least, the report's conclusions suggest that this country has neglected the fundamentals, although it found certain admirable characteristics in the U.S. system compared with Japan's.

In Japan the report may be more helpful in maintaining the momentum for education reform rather than because of its conclusions. By endorsing many of changes was passed last year, the Ministry of Justice is still writing its regulations, as is Nichibenren. Furthermore, the local bar associations have not begun to consider new regulations for foreign lawyers, which could mean further delays.

Japanese government officials are aware of the U.S. position but are not expected to respond until after Nichibenren's annual meeting January 24. Nichibenren is expected to discuss the regulations for foreign lawyers and MOJ will probably take its cue from this debate. In the past the group of Japanese lawyers giving advice on international transactions has been extremely reluctant to open the door to foreigners. While the administration and the ABA feel Tokyo is reneging on a commitment to draft rules with an eye toward foreign legal realities, the government has put off action while waiting for the influential Japanese bar association.

Two factors make the issue more sensitive in 1987. First, the mainstream of the ABA is now demanding freer access to practice in Japan. Major law firms with considerable political clout feel they have given Tokyo enough time to respond and that the response has been insufficient. Various forms of retaliation are being discussed. The second factor is the shift to a Democratic Congress, making retaliatory legislation more likely if Japan is perceived as blocking access to an important services market. With only a short time before the reforms go into effect, Tokyo must tread carefully to defuse the situation.

Jon Choy

Another Year Of Japanese Car Export Limits Expected

Total U.S. retail car sales broke a 13-year-old record in 1986, expanding by 3.7 percent to 11,452,310 units and finally topping the previous all-time high of 11,446,589 cars set in 1973. But this achievement was no cause for celebration in Detroit -- or, for that matter, in Japan. For starters, sales of domestically made cars barely exceeded 1985's figure with volume up just 0.1 percent to 8,214,663 units. Then there was the fact that this slim gain was entirely the result of higher sales of cars assembled by Honda of America Manufacturing Inc., New United Motor Manufacturing Inc. (the Toyota Motor Corp.-General Motors Corp. joint venture) and Nissan Motor Manufacturing Corp. U.S.A., which jumped from 221,364 units in 1985 to 465,637 vehicles last year. For the U.S. Big Three, in short, 1986 marked the end of the turnaround that started in 1983 as non-captive retail deliveries dropped by 179,931 units (2.3 percent) to 7,602,261 vehicles.

With sales of domestic makes stalled, imports had the dubious honor of pushing total U.S. retail sales above 1973's record tally. Purchases of imported cars climbed 14.1 percent to a new high of 3,237,647 units, but as executives of the leading Japanese automotive producers are quick to point out, the fourth consecutive annual increase in foreign car sales was only partly the result of bigger sales of vehicles made in Japan. Sales of Japanese cars added up to 2,375,819 units for a gain of 7.1 percent or 157,959 more cars. Korea's Hyundai Motor Co., though, sold 168,882 cars in its first year of marketing in the United States. Moreover, fully two-thirds (105,819 units) of the extra

U.S. Retail Car Sales, 1981-86

(units)

Manufacturer/Seller	1981	1982	1983	1984	1985	1986
Toyota Motor Corp.	576,491	530,246	555,766	557,981	620,047	633,806
Nissan Motor Co., Ltd.	464,805	470,246	521,902	485,298	535,372	493,549
Honda Motor Co., Ltd.	370,705	365,865	350,670	374,819	406,413	458,268*
Mazda Motor Corp.	166,105	163,638	173,388	169,666	211,093	222,716
Fuji Heavy Industries, Ltd. (Subaru)	152,062	150,335	156,840	157,385	178,175	183,242
Mitsubishi Motors Corp.	0	3,950	32,755	39,104	49,734	49,436
Isuzu Motors, Ltd.	17,805	15,462	20,731	17,233	26,953	38,910
Mitsubishi Motors Corp./Chrysler Corp.	110,940	102,227	103,569	91,718	105,213	135,529
Isuzu Motors, Ltd./General Motors Corp.	0	0	0	2,077	53,968	99,380
Suzuki Motor Co., Ltd./General Motors Corp.	0	0	0	10,927	30,892	60,983
General Motors Corp.	3,796,696	3,515,660	4,053,561	4,587,508	4,607,458**	4,532,798**
Ford Motor Co.	1,380,600	1,345,698	1,571,321	1,979,317	2,070,392	2,066,507
Chrysler Corp.	729,873	691,703	841,622	986,998	1,139,936	1,173,463
American Motors Corp.	136,682	112,433	193,351	190,255	123,449	72,853
Volkswagen of America Inc.	162,445	91,166	85,045	73,838	77,535	73,912
Honda of America Manufacturing Inc.	0	0	50,402	133,601	145,976	235,247
New United Motor Manufacturing Inc./ General Motors Corp.	0	0	0	0	35,594	170,507
New United Motor Manufacturing Inc./ Toyota Motor Sales USA Inc.	0	0	0	0	0	7,281
Nissan Motor Manufacturing Corp. U.S.A.	0	0	0	0	39,794	52,602
Total Japanese Imports	1,858,913	1,801,969	1,915,621	1,906,208	2,217,860	2,375,819
Total Imports	2,326,376	2,221,398	2,382,799	2,439,848	2,836,973	3,237,647
Total Domestic Makes	6,206,296	5,756,660	6,795,302	7,951,517	8,204,540	8,214,663
Total Market	8,532,672	7,978,058	9,178,101	10,391,365	11,041,513	11,452,310
Market Share of Japanese Imports	21.8%	22.6%	20.9%	18.3%	20.1%	20.7%

*Includes 52,869 Acuras.

**Includes the Nova made by New United Motor Manufacturing Inc. (see below).

Source: Automotive News

Japanese imports retailed in 1986 had a General Motors or a Chrysler Corp. nameplate on them.

Automotive industry analysts expect 1987 to be a good year for U.S. car sales but not as strong as 1986. In the consensus view GM, Ford Motor Co. and Chrysler will have trouble matching last year's sales numbers for domestic makes even with the aggressive use of incentives because of a projected cutback in consumer spending on durables and stiffer import competition. That competition is not likely to come from Japan. Trade and industry watchers uniformly take as a given a seventh year of limits on Japan's U.S.-bound car shipments, reasoning that soft demand for the Big Three's products and continued protectionist sentiment on Capitol Hill leave Tokyo no choice but to extend the restraints beyond March 31.

Convinced as well that export restraints have become an institutionalized part of U.S.-Japan trade, American automotive executives and United Auto Workers union officials are trying to win a rollback in the shipment ceiling, which is set at 2.3 million vehicles for the April 1986-March 1987 period. This is hardly a new campaign; however, it did gain an important backer last fall when GM chairman Roger Smith, in an about-face, called on Tokyo not only to continue the restraints but also to reduce the number of cars shipped to this country (see JEI Report No. 39B, October 24, 1986). Moreover, supporters of a rollback have come up with a new justification now that they can no longer use the U.S. industry's weak financial position as the rationale. Their current argument is that the quota should be cut by several hundred thousand units to offset part of the growth of production of "transplants" -- Japanese cars assembled in the United States.

This line of reasoning has drawn a predictable response in Japan. Having accepted Detroit's earlier challenge to manufacture where they market, Japanese car makers wonder why they should now be penalized. The fact remains, though, that the fast-expanding output of transplants will cost Detroit some sales. Honda, which continues to be able to sell every car it can ship to dealer showrooms despite sticker prices that average roughly $1,700 more than in mid-1985, plans to turn out 320,000 Accords and Civics at its Marysville, Ohio plant this year compared with a 1986 total of some 233,440 units. Nissan's Smyrna, Tennessee factory should be able to assemble 150,000 Sentras in 1987, while NUMMI is expected to build about 50,000 Corolla FX-16s for sale by Toyota as well as approximately 200,000 Chevrolet Novas. Adding to the marketing pressure, Mazda Motor Manufacturing (USA) Corp.'s Flat Rock, Michigan facility will come onstream in September 1987.

Susan MacKnight

Notes

- On January 6 the United States announced it was drastically reducing the amount of fish foreign fishing vessels can take within the 200-mile U.S. economic fishing zone. Hardest hit are the Japanese, who may see their haul slashed from 1986's 474,000 metric tons to just 24,776 metric tons. This harsh action has prompted speculation by Japanese fisheries officials that Washington plans to cut the foreign quota to zero next year. Although foreign ships may

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JAPAN'S ENERGY POLICY: 1986 UPDATE

Summary

Two factors -- the glut of crude oil on world markets (and the consequent sharp price drop) and the significant appreciation of the yen against the American dollar -- combined in 1985 and 1986 to goad Tokyo into rethinking fundamental aspects of the nation's energy policy. After a decade of dealing with supply shortages and rapid price increases, end-users were suddenly faced with the exact opposite, leading to calls for changes in government policies. While conservation, supply and utilization diversification will remain key aspects of Japanese energy policy, important changes are being made in price-support, petroleum product import, coal and nuclear policies.

The Aggregate Picture

Supply and Demand - According to the Ministry of International Trade and Industry, Japan consumed 1.6 percent more energy of all types in fiscal 1985, while overall supplies grew 0.7 percent (Tables 1-2). Imported crude oil's part in the supply picture continued to diminish, putting Japan closer to its goal of reducing oil dependence to less than 50 percent. There was a slight rise in oil consumption due mostly to an upsurge in gasoline usage. Overall oil imports declined slightly in 1985 as new Japanese wells came on-line and consumption declined (Table 3). The drop in the price of oil was quite dramatic in 1986 (Table 4) as costs fell 63 percent in dollar terms and 71 percent in yen terms between January and August.

Imports of non-crude-oil energy products showed various responses to the increased price competitiveness of oil-based sources (Tables 5-6). Steam coal imports rose strongly, not because of increased demand for electricity but rather because of deliveries from Australian and Canadian coal mines developed by Japanese operations. Demand for coal for steel and coke making was sluggish since Japanese steelmakers faced weak markets. Liquefied natural and petroleum gases also continued to grow in popularity, probably due to greater industrial use of cogeneration equipment.

Production of electricity continued to expand in 1985 and 1986 in line with growing demand (Tables 7-8). Hydroelectric power supplies recovered in 1985 from the effects of a drought the year before. The biggest change, though, was nuclear power's 19 percent growth, pushing its share of total energy supplies to almost 10 percent, in third place after coal and oil. Japanese nuclear reactors operated at a record rate of capacity, averaging 76.2 percent, a full two percentage points above the previous year.

Consumption - The trends in energy consumption present a mixed picture (Tables 9-10). Japanese households clearly voted in favor of electricity while holding the line on demand for other energy sources. At the same time, the industrial sector's appetite was again restrained, dropping in 1985 and the first few months of 1986. The continuing loss of international competitiveness of Japan's energy-intensive industries accounts for weak demand by some industries. Electricity and propane expanded their share in industry's energy supply picture, continuing the movement away from oil-based and coal sources. According to MITI, industrial restructuring helped keep energy consumption growth down to 0.5 percent in fiscal 1985, counterbalancing the upward push of increased output (Table 11). Not surprisingly, Japanese industry continued to improve its overall energy efficiency in FY 1985. Over a six-year period, the industrial sector has steadily become 26 percent more energy efficient -- an important factor in maintaining international competitiveness (Table 12).

Time For A Change

One would think that everything was coming up roses for consumers and policymakers alike -- prices have fallen, supplies are more than adequate and energy efficiency continues to rise. In fact, Japan is suffering from too much of a good thing. The sharp price declines and oversupply of energy have altered end-user attitudes and put new pressures on policymakers.

Tokyo's complicated structure of import controls, taxes and subsidies stems from actions taken in the immediate postwar years -- actions accepted by businesses and individuals as a necessary part of the reconstruction effort. These measures also proved useful in managing the impact of the oil shocks of the last decade. In the 1980s, however, they have exacerbated the problems. Falling oil prices have put pressure on the carefully regulated pricing policy employed for all types of energy. Since oil is the benchmark, this has brought calls for price cuts on alternative sources of energy from industrial and individual consumers. This trend has been amplified by the appreciation of the yen, since nearly all imported energy sources are bought with dollars.

New refineries in the Middle East are changing the face of global markets for petroleum products. Japan and other Western industrial nations have

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agreed to expand oil product imports to accommodate the expected increase in supplies. Tokyo has been encouraging consolidation and capacity reduction in the oil industry for several years but the international commitment has added a further dimension to the need for structural change.

While the price collapse may be short-lived the other two changes are probably not. The strong yen not only influences prices but may influence demand through a shift away from dependence on export-oriented manufacturing industries. In the medium term, at least, demand is likely to be depressed as the economy adjusts. The competitiveness of Japanese refineries will also suffer from the yen's rise, which has made foreign refined products even cheaper. This, coupled with refinery overcapacity, will put extreme pressure on Japanese oil companies and government policies that favor them.

Oil Policy

The market for crude and refined petroleum products in Japan is tightly controlled by the government. Import restrictions, production guidelines and price structures form a tight network under the guidance of the Ministry of International Trade and Industry (through its Natural Resources and Energy Agency). A ban on the imports of highly refined petroleum products plus fixed prices encouraged Japanese oil companies to over-build refinery capacity. This, along with a plethora of retail outlets for gasoline and controlled prices for kerosene and other products, has depressed oil company earnings for the past several years. The global glut of oil, the strong yen and slower economic growth have all combined to change this.

For the first half of fiscal 1986 (April-September), eight major Japanese oil companies reported sales declines of between 20 and 39 percent, although they earned enough to put them in the black. In fact, profits due to exchange rate changes (Y36.8 billion or $237.4 million at Y155=$1.00) were greater than normal operating profits (Y30.5 billion or $196.8 million). While this was a welcome development, oil company officials were more interested in pressing MITI to ease its controls so they could take advantage of the yen's strength, import more refined products and price their products more competitively.

At the same time Japan's 1985 commitment to the International Energy Agency, made up of Western industrial oil-consuming nations, also put pressure on MITI to liberalize imports of refined products. After prodding by allies and the prime minister, MITI issued licenses at the beginning of 1986 to the major oil companies to import gasoline on a limited scale. Imports rose from 3.3 million barrels in the first quarter of 1986 to 6.7 million in the third quarter. Although this amounted to just 12 percent of domestic production, it is still a significant improvement.

This hole in the policy dike only encouraged oil companies and end-users to press for greater reforms, leading to MITI's decision in November 1986 to establish the Committee to Study Basic Problems of the Oil Industry. By June the group hopes to draft a program to liberalize and rationalize the entire oil industry over a five-year period beginning in fiscal 1987. The committee will review current policies relating to both production and sales in view of new long-term supply projections, oil product trade, and oil stockpiling policies.

A guiding principle is the replacement of government controls with free-market mechanisms. MITI also plans to accelerate its program to reduce refining capacity. (Japanese refineries operate at only about 60 percent of capacity, compared with average rates of over 70 percent for facilities in Europe and the United States.) Policymakers will also scrutinize the country's labyrinthine fuel distribution system to improve the entire industry's international competitiveness. MITI apparently wants to make Japan a more hospitable market for major international oil companies as well as oil suppliers.

In December 1986 MITI began issuing oil product export licenses to oil companies. Ministry officials hope that this will help alleviate the pressures of slack domestic demand but expect that exports will be extremely limited in scope. For one thing, exports to the United States and South Africa are not permitted; for another, government and industry officials agree that when the costs of bringing crude oil all the way to Japan are considered, a reasonable export price will be difficult to achieve. At the moment Japanese oil companies are using the new flexibility to arrange swap deals with Southeast Asian producers. Mitsubishi Oil Co., Ltd., for example, will swap 145,000 barrels of gasoline for an equal amount of Bintulu condensate from Malaysia's state-run Petronas oil company. In any event, MITI will evaluate export licenses on an individual basis to insure that prices and supplies are not distorted.

MITI has already begun to allow markets more freedom to set prices, as indicated by the fact that retail prices for gasoline, kerosene and propane have been allowed to drift downward. Gasoline prices in the Tokyo metropolitan area fell from Y143 ($0.92) per liter in January 1986 to Y120 ($0.77) in October; kerosene dropped Y280 ($1.81) per 18 liters to Y1,116 ($7.20); and propane declined from Y5,109 ($32.96) per 1,000 cubic meters to Y4,865 ($31.39). While these adjustments do not match the fall in import prices, they do represent an easing of the ministry's hard-line policy.

Coal Policy

The sharp drop in crude oil prices plus the opening of several Canadian and Australian coal mines precipitated a crisis for the domestic coal industry in 1986. Both factors pushed prices of all types of coal down so much that the price differential between a metric ton of domestic coal and imported coal reached a stunning Y16,000 ($103.22). Japan's steel and power companies have been forced to buy the price-supported domestic coal, adding as much as Y100 billion ($645.1 million) to their annual fuel costs. Facing a deep depression, Japanese steel companies rebelled against the government's policy and refused to purchase domestic coal. After intense negotiations with MITI in October, the domestic price of coking coal was reduced by Y1,000 ($6.45) per metric ton to Y23,280 ($150.19) effective April 1, 1987, and steel makers will be allowed to purchase as much as 46 percent less domestic coal. This pact encouraged electric utilities and other major users of steam coal to press the ministry for a similar arrangement. MITI was less sympathetic to their claims but in the end agreed to reduce the price of domestic steam coal by Y500 ($3.23) per metric ton to Y19,470 ($125.61) for FY 1987.

Not surprisingly, these developments were greeted with dismay by the coal industry. In the wake of the price cuts, every major mine announced plans to slash output and employment; some went so far as to threaten a complete shutdown. Fortunately, MITI was in the midst of drawing up a new five-year coal policy and after closed-door talks, released its 8th Coal Policy in mid-November. The report recognizes that the price differential between domestic and foreign coal has reached the point where the domestic industry is no longer viable in its present form. It recommends rapid consolidation and capacity reduction in the domestic industry, suggests the government establish a coal stockpile to absorb some domestic production until the mines can be closed, and proposes employment adjustment assistance for industry employees. Users will be allowed to slowly reduce their purchases of domestic coal except for the power companies, which will be forced to continue to purchase as much as 8.5 million metric tons a year.

By 1991 the government expects domestic output to fall to 10 million metric tons a year, well below the current 16 million metric ton level. This will probably force six to eight of the eleven operating mines to close. The resulting layoffs will surely strain the resources of the prefectural governments. The Ministry of Labor is planning new job training and other adjustment programs for the areas expected to be hardest hit.

New Energy Vision

It is not surprising that all this ferment prompted MITI to begin work on a new energy analysis, referred to as a "vision." Unlike the committee studying a new oil policy, this study group drafted a report long on generalities. The vision was to serve as a guide to reforming policies to meet demand as far in the future as the year 2030.

The report, which was released this past December, anticipates that the use of oil in Japan will continue to decline, replaced by coal, natural gas and nuclear power. In addition, solar, geothermal, biomass and other alternative energy sources will be in full-scale use. This will present users with a much wider choice of energy sources and will lead to the widespread use of decentralized power systems. Assuming this last development occurs, the proportion of purchased energy will decrease as neighborhoods or factories are supplied by a local power source, independent of a utility's power grid. Nevertheless, electricity is seen as the dominant form of energy because it can be generated from many sources. Transportation, according to the report, will be driven by non-oil based fuels -- hydrogen, methanol and ethanol.

This is described as the multiple energy era, which means that a high degree of diversification of supply will be achieved, increasing energy security and enhancing energy supply flexibility. The government's responsibility is as follows:

- To develop energy-related technologies - "Technological advances can bring fundamental solutions to energy problems by reducing real dependence on foreign energy; bringing flexibility to energy supplies; promoting energy efficiency; and improving the quality of life by introducing new appliances."

- To establish an appropriate competitive environment - Starting with an effort to decentralize energy sources, it must create conditions that are responsive to changing demands and that facilitate technological development. A smooth shift to a price system based on competition among all forms of energy will be necessary (i.e. the price of oil will cease to be a benchmark).

- To formulate a strategic international resources policy - A vision of the future structure of industry must guide the internationalization of the oil industry and the development of new energy sources. This effort should include not only evening out periods of peak demand but also coordinating international energy policy, stabilizing global oil markets, and coordinating international studies of environmental problems.

The authors of the study note that if new policies are not implemented, Japan's energy consumption could grow by 2.4 percent annually through the year 2000 and 1.3 percent thereafter, reaching 860 million kiloliters of crude oil equivalent. If new policies are enforced, consumption is forecast to grow by 1.6 percent a year until 2000 and 0.8 percent through 2030, translating into total consumption of 660 million kiloliters of crude oil equivalent annually. The prospect of achieving the same amount of economic growth using nearly 25 percent less energy is certainly tempting.

Conclusion

Events of the past two years have had as great an impact on Japanese energy policy as the oil shocks of the 1970s. In some ways, it amounts to a "reverse" oil shock -- sharp price declines coupled with a glut of supplies. While supply almost certainly will come back into line with demand, it is unclear if prices will ever climb back to their previous levels. Amplified by the stronger yen, this change has forced Tokyo to review its basic energy policies.

A fundamental shift is taking place. Tokyo is beginning to move away from tight central control over all aspects of energy markets and is embracing policies more open to international markets. This clearly implies a great number of changes, both in government and the private sector. It also opens opportunities for foreign energy companies since Japan will certainly scour the globe for answers to its problems. It is a time of change for Japanese energy policy, hopefully for the better.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Japan's Energy Consumption by Source, FY 1985

(in millions of kiloliters of crude oil equivalent and percent change)

	Industry	Transportation	Other	Total
Oil	83.3	63.4	35.1	181.8
	(-2.0%)	(2.2%)	(2.9%)	(0.3%)
Coal	56.6	0	0.4	56.9
	(0.9%)	--	(-14.6%)	(0.8%)
Electricity	82.6	3.5	62.4	148.5
	(2.1%)	(2.3%)	(5.1%)	(3.3%)
Propane	3.1	0	10.2	13.3
	(8.9%)	--	(3.4%)	(4.6%)
Others	10.8	0.3	1.1	12.3
	(-1.0%)	(6.3%)	(7.9%)	(-1.0%)
Total	236.3	67.3	109.2	412.8
	(0.2%)	(2.2%)	(4.2%)	(1.6%)

Source: Ministry of International Trade and Industry

Table 2: Japan's Energy Suppply by Source

(in millions of units)

	FY 1984			FY 1985			
	Actual	Crude Oil Equivalent	Share	Actual	Crude Oil Equivalent	Share	Percent Change
Oil (kl)	259.6	259.6	59.6%	248.7	248.7	56.7%	-4.2%
Coal (mt)	106.2	80.5	18.5	110.9	83.6	19.1	3.8
Nuclear (kw)	20.7	35.0	8.0	246.9	41.7	9.5	19.0
Natural Gas (kl)	40.0	40.0	9.2	41.3	41.3	9.4	3.4
Hydroelectric (kw)	33.9	19.1	4.4	34.5	21.7	4.9	13.6
Alternatives (kl)	1.5	1.5	0.4	1.7	1.8	0.4	8.8
Total		435.8	100.0		438.8	100.0	0.7

Source: Ministry of International Trade and Industry

Table 3: Japan's Crude Oil Imports, Production and Inventories

(in thousands of barrels)

	Production	Imports	Throughput	Rate of Operation	Inventories
1980	3,177	1,615,480	1,462,123	67.3%	238,020
1981	2,868	1,448,203	1,321,353	60.9	226,302
1982	2,937	1,350,369	1,225,566	56.5	205,916
1983	3,095	1,307,024	1,181,136	56.9	185,870
1984	2,994	1,349,847	1,220,958	67.1	163,905
1985	3,931	1,247,496	1,130,973	62.3	160,288
1986					
1st Qtr	1,201	656,498	314,827	70.3	170,592
2nd Qtr	1,207	262,339	240,566	53.2	151,936
3rd Qtr	1,118	300,317	247,069	54.0	187,298

Source: Petroleum Association of Japan

Table 4: Price (c.i.f.) of Imported Crude Oil

	Volume (1,000 bbl)	Value ($millions)	Dollars per bbl	Yen per kiloliter
1980	1,600,352	$52,749	$32.97	Y47,197
1981	1,430,623	53,343	37.29	51,387
1982	1,334,958	46,266	34.66	53,906
1983	1,302,055	40,063	30.77	45,923
1984	1,314,034	39,379	29.36	43,713
1985	1,232,494	34,600	28.07	42,374
1986				
January	96,891	2,691	27.77	35,297
February	119,655	3,299	27.57	33,562
March	113,805	2,548	22.38	25,368
April	104,074	1,713	16.46	18,489
May	85,443	1,101	12.89	13,548
June	83,682	1,033	12.35	13,146
July	90,468	1,075	11.88	12,191
August	104,122	1,076	10.34	10,081
September	95,042	1,030	10.84	10,545
October	96,781	1,235	12.76	12,382

Source: Ministry of Finance

Table 5: Japan's Non-Crude Oil Energy Imports

(in thousands of units)

	Coal (mt)	Naphtha (kl)	Fuel Oil (kl)	LPG (mt)	LNG (mt)
1980	68,570	7,363	7,431	9,725	16,324
1981	77,959	7,241	7,404	10,097	16,833
1982	78,535	8,998	6,893	11,861	17,480
1983	75,124	13,096	7,285	10,860	18,748
1984	87,227	13,414	7,342	11,320	25,738
1985	93,448	14,896	7,493	11,540	27,556
1986					
January	8,168	1,577	473	883	2,540
February	6,932	1,122	485	969	2,274
March	7,178	1,223	724	1,156	2,476
April	8,091	1,200	370	1,048	2,171
May	7,750	1,255	548	952	2,282
June	7,655	1,381	517	776	2,084
July	8,618	1,461	655	967	2,360
August	7,039	1,519	430	788	2,346
September	7,655	1,761	651	929	2,470

Table 6: Japan's Consumption of Non-Crude Oil Energy

(in thousands of units)

	Coal (mt)			Heavy Fuel Oil (kl)				LPG (mt)			LNG (mt)	
	Coke	Steel	Power	Agri-culture	Manufac-turing	Ship-ping	Power	Chemi-cals	Power	Motor vehicles	Resi-dential	Power
1980	2,859	58,896	1,671	6,433	43,747	6,154	38,360	4,485	3,327	1,548	3,180	12,554
1981	3,906	60,854	4,082	6,444	35,690	4,730	34,5[illegible]	4,465	2,707	1,241	3,411	12,857
1982	3,389	59,447	5,233	6,323	30,209	4,365	30,983	4,465	2,707	1,241	3,411	12,857
1983	3,652	54,570	7,742	5,707	27,769	4,112	29,476	4,047	3,082	1,822	4,195	14,039
1984	4,069	62,716	9,424	6,086	26,655	4,909	29,220	5,029	3,381	1,843	5,561	19,606
1985	4,908	63,961	13,884	1,303	24,853	4,709	22,271	5,176	3,321	1,722	5,589	21,396
1986												
January	419	5,247	1,598	237	2,241	375	1,888	494	278	136	644	1,838
February	432	4,853	993	241	2,139	384	1,826	416	271	111	540	1,676
March	324	4,881	1,049	172	2,071	390	1,814	387	330	129	664	1,755
April	355	5,620	1,169	94	2,001	376	1,331	410	274	132	616	1,498
May	531	5,137	1,154	78	1,773	358	1,137	353	276	162	567	1,657
June	313	5,447	1,197	63	1,653	361	1,080	439	259	135	522	1,562
July	416	5,793	1,310	59	1,939	394	1,651	415	286	164	424	1,935
August	289	5,019	1,083	38	1,713	344	1,599	452	263	159	389	1,900
September	532	4,623	1,096	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	448	1,965

Source: Ministry of International Trade and Industry

Table 7: Output of Electric Utilities in Japan

(in billions of kilowatt hours)

	Total	Hydro	Thermal	Nuclear
1980	514.05	85.15	346.90	82.01
1981	523.14	83.74	352.18	87.23
1982	522.48	77.34	343.30	101.84
1983	555.49	81.39	360.98	113.12
1984	580.41	70.65	378.32	133.23
1985	603.93	81.19	363.75	158.98
1986				
January	52.00	5.03	32.00	14.97
February	49.22	3.66	32.12	13.45
March	51.16	5.01	31.74	14.41
April	46.28	8.16	25.84	12.28
May	46.35	10.41	23.20	12.73
June	48.35	8.78	24.63	14.94
July	54.67	10.26	29.11	15.29
August	56.09	6.94	34.20	14.59

Table 8: Japan's Electricity Consumption

(in billions of kilowatt hours)

			Power				
				Manufacturing			Rail-roads
	Total	Light	Total	Total	Chemicals	Steel	
1980	464.25	105.27	353.98	190.77	26.79	61.80	12.71
1981	470.56	110.30	360.27	184.29	26.28	58.49	12.86
1982	471.44	112.79	358.65	177.95	29.22	53.69	13.06
1983	499.78	122.22	377.57	182.62	27.55	55.47	13.33
1984	524.53	127.51	397.02	191.97	28.76	57.04	13.13
1985	541.39	133.30	408.09	193.75	28.23	55.88	13.44
1986							
January	48.05	13.79	34.26	15.46	2.31	4.54	1.25
February	45.65	12.29	33.36	15.26	2.15	4.34	1.11
March	44.43	11.08	33.35	16.06	2.23	4.63	1.18
April	43.37	11.05	32.32	15.57	2.22	4.49	1.05
May	42.36	10.50	31.86	15.29	2.22	4.41	1.07
June	41.52	9.16	32.36	15.84	2.31	4.37	1.05
July	44.69	10.04	34.65	15.90	2.15	4.17	1.15
August	49.60	12.65	36.96	14.71	2.10	3.95	1.21

Source: Ministry of International Trade and Industry

Table 9: Household Energy Consumption in Japan

	Electricity (mil kwh)	Propane (bil kcal)	Kerosene (1,000 kl)	LPG (1,000 mt)	Other Solids (1,000 mt)	Coal (1,000 mt)
1980	103,199	56,008	16,725	4,984	1,212.3	578.5
1981	108,979	58,178	16,730	5,336	970.0	472.5
1982	110,051	58,200	15,275	5,295	1,173.0	512.8
1983	117,905	60,748	15,928	5,460	1,010.3	509.2
1984	125,588	66,065	17,130	5,696	1,413.2	469.1
1985	129,682	65,706	16,060	5,611	1,479.3	371.9
1986						
January	13,682	8,591	2,825	625	119.8	27.1
February	12,179	8,392	2,777	594	114.6	33.0
March	10,982	7,929	2,150	558	97.1	37.3
April	10,951	7,085	1,070	535	84.0*	7.8
May	10,396	5,913	640	492	81.3*	12.1
June	9,047	4,541	479	403	79.3*	18.9
July	9,899	4,242	472	381	67.6*	18.3
August	12,491	3,698	n.a.	n.a.	63.3*	20.6

*Partial data only.

Source: Ministry of International Trade and Industry

Table 10: Energy Consumption by Industry in Japan

(in kiloliters of crude oil equivalent)

	Metal Mining	Coal Mining	Textiles	Pulp, Paper and Cardboard	Chemicals	Petro-chemicals
1983	85,704	663,943	4,023,117	10,480,791	57,216,628	10,671,659
1-3 Qtr	61,799	466,083	2,977,585	7,790,477	42,848,661	7,869,633
1984	73,995	657,159	4,213,267	10,731,896	66,206,821	10,759,857
1-3 Qtr	55,046	485,572	3,159,121	7,977,411	49,082,889	8,010,169
1985	73,747	635,692	4,218,646	10,838,465	66,477,596	10,374,103
1-3 Qtr	55,346	471,932	3,135,525	8,063,115	49,342,700	7,713,921
1986						
1-3 Qtr	46,933	468,709	3,230,786	8,174,471	49,986,045	7,452,444

	Rubber Products	Nonmetallic Mineral Products	Steel	Nonferrous Ores and Metals	Machinery	Total
1983	421,307	15,482,503	45,462,302	4,375,242	13,676,921	133,909,803
1-3 Qtr	309,581	11,457,460	33,573,380	3,218,485	10,071,169	98,719,393
1984	428,331	14,493,878	50,509,329	4,427,235	15,249,193	142,880,126
1-3 Qtr	320,707	10,645,697	37,649,656	3,315,428	11,356,481	106,271,750
1985	415,468	13,527,752	50,763,316	4,250,973	15,393,058	141,789,300
1-3 Qtr	310,002	9,989,067	38,338,090	3,195,750	11,575,837	105,657,475
1986						
1-3 Qtr	325,611	9,309,195	35,671,539	3,026,657	11,015,656	103,956,811

Source: Ministry of International Trade and Industry

Table 11: Composition of Industrial Energy Consumption Changes in Japan

(in millions of kiloliters of crude oil equivalent)

	Overall Change in Consumption	As a Result of: Output Changes	Industrial Structure Changes	Unit of Measure Changes
FY 1980	-10.1	0.2	-7.4	-2.9
FY 1981	-13.8	1.0	-4.8	-10.0
FY 1982	-9.6	-2.8	-2.1	-4.7
FY 1983	5.3	10.4	-1.7	-3.4
FY 1984	7.2	14.9	-4.1	-3.6
FY 1985	0.5	4.6	-3.5	-0.6

Source: Ministry of International Trade and Industry

Table 12: Japan's Industrial Energy Efficiency

	Industrial Production Index (1980 = 100)	Industrial Energy Consumption Index (millions of kl of oil)	Derived Energy Efficiency Index (FY 1979 = 100)
FY 1979	99.0	231	100
FY 1980	99.1	218	94
FY 1981	99.6	202	87
FY 1982	98.1	186	81
FY 1983	103.9	191	79
FY 1984	112.4	198	76
FY 1985	115.0	199	74

Source: Ministry of International Trade and Industry

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Yen Rises To New Postwar High

On January 19 the yen hit its highest level since April 1949 when the Japanese currency was pegged at Y360=$1.00. The yen's renewed appreciation has alarmed Japanese government officials concerned about its deflationary effects on the economy. In a record $10.2 billion volume of trading on the Tokyo market, the yen cleared the Y150=$1.00 barrier before closing at Y150.45, breaking the previous high of Y152.55 set last August 20. The dollar's decline came despite massive intervention by the Bank of Japan estimated at between $1 billion and $2 billion. Japan's currency has risen 6.4 percent in relation to the dollar since the first of the year and 60.9 percent since the September 1985 Group of Five meeting.

Satoshi Sumita, governor of the Bank of Japan, promised to continue to intervene to promote exchange rate stability, which he said is the key to the recovery of Japan's economy. The government's FY 1987 outlook of 3.5 percent

Japan Distills Liquor Taxes

Japan and the European Community are making progress in solving a dispute over Tokyo's liquor taxes that should help put relations back on a friendlier footing. The EC, whose members have a comparative advantage in this area, has long urged Tokyo to reduce and simplify its system of commodity taxes on alcoholic beverages. As Japan's trade surplus with the community increased to $11 billion in 1985 and over $13 billion in the first nine months of 1986, the EC decided to make the issue a test of Tokyo's good will. Japanese officials then came up with a package of tax cuts and classification changes that would significantly lower the prices of imported alcoholic beverages, but the Europeans were not satisfied.

The EC, the United States and other countries have sought changes in Japan's liquor taxes for several years. Although makers of distilled alcoholic beverages were the first to support the issue, they have been joined over the years by producers of wine and beer. The principal foreign complaints are that Tokyo levies a tax on both value and quantity as well as a variable tax based on quality, and that the classification system employed discriminates against foreign products. For example, Scotch whiskey is distilled from pure malt and grain, putting it in the special category for whiskey that is taxed at over Y2,000 ($12.90 at Y155=$1.00) a liter. Many brands of domestic whiskey, on the other hand, contain alcohol blended from several sources. These are graded as second class and are taxed less than Y300 ($1.94) a liter. In light of its traditionally strong export position in alcoholic beverages, the Europeans have taken the lead on this issue.

During the last annual ministerial talks, December 11-12, Tokyo announced that it would review liquor taxes as part of its overall tax reform program (see JEI Report No. 46B, December 19, 1986). The Europeans made it clear that a partial reform would not be satisfactory and that it would indicate the lack of importance Japan attaches to the relationship. The EC leadership underscored its position by moving ahead with plans to ask for consultations under the auspices of the General Agreement on Tariffs and Trade. Such a hard-line position seemed hasty since Tokyo had not yet developed concrete proposals.

True to its word, Tokyo proposed December 24 a thorough reform of liquor taxes effective April 1, 1988. Not only will several special classifications that apply mainly to foreign products be eliminated but taxes will be reduced to one-half to one-seventh of their current levels (see Table). The plan would mean an end to taxes based on value and almost complete simplification of the quality-based levy. The Ministry of Finance hopes to phase out the remaining tax on whiskey and brandy based on the percentage of malt over a five-year period.

The Europeans welcomed the plan but said it did not go far enough. The EC Commission lamented that "Even if the proposal finally establishes a uniform fiscal regime for wines and liqueurs, it still discriminates against alcohols." The commission plans to continue with the GATT consultation process. Tokyo is hoping that the combined impact of tax reform and the strong yen will boost imports of alcoholic beverages and ease the situation. Both European and American distillers, vintners and brewers stand to gain from the changes.

Jon Choy

Proposed Liquor Tax Reform

(in yen per kiloliter)

	Typical percentage of alcohol	Current tax	Proposed tax
Sake			
Special class	15%	Y570,600	*
First class	15	279,500	Y218,500
Second class	15	107,900	67,800
Synthetic sake	15	81,500	55,100
Shochu (spirits of Japanse origin)			
Type A	25	78,600	52,100
Type B	25	50,900	21,900
Mirin (sweetened Japanese rice wine)			
Type A	13.25	74,100	40,700
Type B	22	63,500	39,400
Beer	n.a.	239,100	206,100
Fruit wine			
Pure fruit wine	n.a.	60,400	*
Other fruit wine	n.a.	49,700	20,100
Sweetened wine	12	117,3[illegible]	63,900
Whiskey and Brandy			
Special class	43	2,098,100	1,636,380**
First class	40	1,011,400	1,522,200**
Second class	37	296,200	***
Other Spirits	37	361,800	243,800
Liqueurs			
Type A	15	367,000	*
Type B	12	117,000	63,900
Miscellaneous Liquors	12	117,300	63,900

*Combined with following class

**Although special class will be combined with first class, the tax is based on different alcoholic strengths.

***Classified with Other Spirits

Source: Ministry of Finance

The Soviet overtones of the Kuranari tour were more pronounced in his comments to the Japan-Australia Ministerial Committee January 8. Mr. Kuranari warned of efforts to expand Soviet influence in the Pacific through military, economic and political means, declaring that such a concerted drive could have serious negative consequences for the stability of the region. His concern was underscored by his final stopoff in Vanuatu, which recently completed a fishing rights agreement with the Soviets.

As Mr. Kuranari was delivering his message in the Pacific, the prime minister ventured to Eastern Europe and neighboring countries, again establishing another first. While the tour demonstrated to his domestic political audience the prime minister's international leadership, it was intended to raise Japan's profile in this region and perhaps facilitate expanded contacts between Poland and members of the West, including Japan, through high-level visits by foreign officials. It was also clear that Mr. Nakasone wanted to communicate to the Soviet Union Tokyo's concerns over Asian policy proposals announced by Soviet leader Mikhail Gorbachev in Vladivostok July 28, 1986 (see JEI Report No. 29B, August 8, 1986). Finally, he sought to stimulate his planned exchange of visits with Mr. Gorbachev.

Discussions on this final point ground to a halt following the difficulties arising between the United States and the Soviet Union in the November 1986 mini-summit. At one point the possibility of Mr. Gorbachev's coming to Tokyo in January 1987 seemed realistic, but now Soviet officials are alluding vaguely to the possibility of renewing talks in the late spring.

Michael W. Chinworth

Notes

- The latest available figures on Japan's 1985 official development assistance showed a continuation of the secotral patterns established in recent years, with 43 percent of bilateral funds going to public utility projects (see Table). Agriculture and fisheries projects received the next-largest amount -- some 17 percent of total commitments. Emphasis on social infrastructure and welfare projects declined in contrast to the continued hikes that sector had seen in previous years, while education and industry, mining and construction both recorded sizable increases.

Distribution of Japan's Bilateral ODA Commitments, 1984-85*

(in millions of dollars)

	1984	1985	Percent Change 1984/85	Percent of Total 1983	Percent of Total 1984
Public utilities	$1,605.4	$1,756.6	9.4%	40.5%	43.1%
Planning and public administration	14.6	25.8	76.7	0.4	0.6
Agriculture and fisheries	497.5	699.5	40.6	12.5	17.2
Industry, mining and construction	388.7	432.1	11.2	9.8	10.6
Trade, banking, tourism and services	50.7	18.7	-63.1	1.3	0.5
Education	188.4	317.8	68.7	4.8	7.8
Health	138.8	161.9	16.6	3.5	4.0
Social infrastructure and welfare	170.2	117.7	-30.8	4.3	2.9
Multisector	88.1	98.6	11.9	2.2	2.4
Unspecified	60.8	144.6	137.8	1.5	3.6
Not allocable by sector**	764.7	302.4	-60.5	19.3	7.4
Total	3,968.0	4,075.6	2.7	100.0	100.0

*Commitment basis

**Includes commodity loans, food aid, debt relief and other types of aid.

Source: Ministry of Foreign Affairs

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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Baker And Miyazawa -- Round Two

In their January 21 meeting in Washington, Treasury Secretary James Baker and Finance Minister Kiichi Miyazawa reaffirmed their October 31 agreement to cooperate on exchange market issues (see JEI Report No. 41B, November 7, 1986). In a four-paragraph statement issued after the meeting, the two developed countries that followed sound domestic policies, he suggested. The resulting economic growth would obviously benefit the debtor nations but would also provide the United States with more lucrative export markets. On the domestic side, he maintained that the government should take steps to shrink the gap between domestic savings and investment and improve lagging productivity by stimulating education, research and development, and the availability of capital.

According to Mr. Greenspan, the ideal solution to the U.S. trade deficit would be a "continued gradual reduction in the exchange rate of the dollar" to enable U.S. producers to improve their competitive position. As for trade legislation, he stressed that Congress should focus on facilitating the adjustment of domestic industries by improving training programs and resource mobility.

Mr. Dornbusch suggested that a confluence of international economic factors has made a decline in our standard of living inevitable. He said that the best policy option would be to minimize and hasten the decline by implementing exchange rate, interest rate and federal budget adjustments. He also concentrated on the significance of the LDC debt crisis, which he said has slashed U.S. exports of manufactured products to developing countries by more than $40 billion since 1980. Consequently, he favored addressing the issues of third world debt by providing debt relief similar to that proposed by Sen. Bill Bradley (D, N.J.).

With regard to U.S. trade law, committee members seemed anxious to devise a system that would require some sort of relief for injured industries but would be flexible enough to allow the president to pursue other economic and strategic goals. All agreed, however, that while such a balance is highly desirable, it will be difficult to legislate. Moreover, there were questions about dealing with the problem of reciprocity. Mr. Hormats discouraged a sectoral "eye-for-an-eye" approach, suggesting a flexible law that would allow for market access trade-offs between sectors -- a result that could substantially benefit the United States.

All in all, the first set of Senate trade hearings was extremely general, and purposely so. Committee members spent most of their time gauging the opinions of witnesses and collecting ideas about legislative solutions. Perhaps the most commonly asked question was, "How do you suggest we do that?" The senators seemed to be testing as many ideas as possible before hearing administration testimony. Discussions with executive branch officials will begin February 19 in the Finance Committee and February 10 in the House Ways and Means Committee, following some early February hearings with private-sector representatives.

Eileen Marie Doherty

Tokyo Makes It Official: Car Limits To Continue

Protectionist pressures have institutionalized restraints on Japan's U.S.-bound car shipments. International Trade and Industry Minister Hajime Tamura acknowledged as much in announcing January 27 that exports of cars to this country would remain capped at 2.3 million units through March 1988. But the decision to limit shipments for a seventh year won Tokyo few political points, whether on Capitol Hill or in Detroit, because it did not offer a quick fix for the bulging bilateral trade deficit, roughly half of which is attributable to U.S. imports of Japanese-made cars, trucks and automotive parts. Continued restraints "will not influence the course of trade legislation in Congress nor provide significant help to U.S. automakers and their employees," said Sen. John Danforth (R, Mo.) echoing the sentiments of other congressional supporters of increased protection for American automotive producers.

Ford Motor Co., Chrysler Corp. and the United Auto Workers union also gave Tokyo's announcement short shrift. Taking another year of restraints as a given, they had recently stepped up their campaign for a rollback in the export ceiling, which has been set at 2.3 million units a year since April 1985 (see JEI Report No. 2B, January 16, 1987). This option was apparently considered by the Japanese government. Proponents argued that it might rob the protectionist movement of some of its momentum while not costing exporters any sales. Like virtually every American automotive industry analyst, they reasoned that the combination of softer U.S. car demand, expanded competition from other offshore suppliers, high sticker prices for Japanese nameplates and the fast-increasing output of U.S.-assembled Japanese models ruled out any chance that the American import units of Japan's motor vehicle makers could repeat their 1986 sales results.

These arguments did not sway MITI. Rejecting the conventional wisdom in this country, Mr. Tamura said the ministry believed exporters would ship more than 2.3 million cars to the United States over the April 1987-March 1988 period in the absence of any restraints. Therefore, by maintaining the shipment cap at its FY 1985-FY 1986 level, Tokyo was in effect cutting exports.

Having extended the export restraints for yet another year, MITI must now decide how many cars individual manufacturers can ship to the United

Unofficial Quota Allocations, FY 1981-FY 1986

(in units)

Exporter	FY 1981-FY 1983 Quota	FY 1984 Quota	FY 1985-FY 1986 Quota
Toyota Motor Corp.	516,659	551,792	620,800
Nissan Motor Co., Ltd.	456,030	487,040	547,900
Honda Motor Co., Ltd.	348,631	372,338	428,600
Mazda Motor Corp.	159,282	173,468	229,700
Mitsubishi Motors Corp. (including sales to Chrysler Corp.)	112,584	122,612	186,200
Fuji Heavy Industries, Ltd.	70,014	76,250	117,200
Isuzu Motors, Ltd. (including sales to General Motors Corp.)	16,800	49,500	117,100
Suzuki Motor Co., Ltd. (for sale to General Motors Corp.)	0	17,000	52,500
Total*	1,680,000	1,850,000	2,300,000

States. Unofficial sources in Japan say this will not be the pro forma decision it was in 1986. Daihatsu Motor Co., Ltd., the only car manufacturer that does not have a quota allotment, wants to begin U.S. sales this year, while Japan's other small exporters still feel shortchanged by MITI's allocation system. Obviously, the only way the ministry can accommodate second-tier makers is to cut the quotas of the top exporters -- Toyota Motor Corp., Nissan Motor Co., Ltd. and Honda Motor Co., Ltd. On paper Honda is the most likely candidate because it has the largest U.S. production capacity, but whether the number-three import seller is willing to be penalized for having pioneered onshore assembly is another question.

Susan MacKnight

Spring Wage Offensive Has Weak Start

The strong yen has severely weakened the position of Japanese labor unions at the outset of the nation's annual wage negotiations. Every major industry has reported a sharp drop in profits and forecasts slow business conditions this year. In addition, union members are extremely concerned about job security because of manufacturers' plans to expand overseas production. On top of all this, the government is encouraging firms to offer customary wage hikes to help pump up domestic spending. Labor and business leaders will have a difficult time satisfying these conflicting demands.

The 60 percent appreciation of the yen over the past 16 months has put strong pressure on the normal operating profits of every export industry, especially motor vehicles and electronics. Most Japanese firms have been able to prevent profits from disappearing completely by accepting paper-thin margins and instituting cost-cutting measures. Shipbuilding and steelmaking, two industries that have traditionally set the pace for wage settlements, have experienced particularly dismal business conditions.

Since these firms represent the core of the Japanese economy, it is not surprising that the shockwaves have been widespread. While big companies may be able to weather the storm, small businesses have less room to adapt. Subcontractors have been forced to accept price cuts, and low-technology export industries, such as ceramics and cutlery, have been very hard-hit. According to Tokyo Shoko Research Co., Ltd., as many as 623 of the 17,476 bankruptcies in 1986 could be attributed to the impact of the stronger yen -- almost 50 percent higher than the number recorded in the yen surge of 1978.

Poor business conditions have also contributed to the gradual increase in unemployment. Although structural factors, including more part-time and female workers, were increasing the workforce at the same time that increased automation of production and slower overall economic growth were reducing the growth in job openings, it was the strong yen that pushed the unemployment rate up to a postwar record of 2.9 percent last August. Tokyo predicts that the jobless rate will hit 2.9 percent for fiscal 1986, up sharply from FY 1985's 2.6 percent level.

The Japan Federation of Employers' Associations (Nikkeiren) has warned workers not to expect any wage increases this year. Each company must be treated differently according to its financial health, with particular weight given to the influence of the yen. Nikkeiren warned, however, that even in areas of strong growth, such as service industries, wage increases may blunt Japan's international competitiveness.

Despite all these problems, some labor leaders have called for wage hikes equal to those won last year, an average 4.5 percent (see JEI Report No. 17B, May 2, 1986). This increase, they claim, combined with the government's proposed tax reform program would give domestic demand a major boost, offsetting some of the drag from weaker exports. This position is backed by the government, but even this is unlikely to sway employers.

Union cohesion, an important weapon in wage talks, is fragmenting. The steel, shipbuilding and coal mining unions, the traditional pacesetters in wage negotiations, have shelved any hopes of wage increases as management strives to restore financial health. Instead they have focused on job security. Unions associated with the Japanese National Railways, also traditional pacesetters, have been wracked by the government's plans to privatize and rationalize the giant rail system, neutralizing any impact they may have had on nationwide wage talks. Even workers in the industrial and consumer electronics industries, where the highest wage increases have been granted in the past several years, are under heavy pressure from management.

The fact that the increase in the average winter bonus for 1986 dropped to an 11-year low is probably a harbinger of things to come. Employees received an average bonus of Y582,103 ($3,755 at Y155=$1.00), just 0.83 percent above 1985, according to a Nihon Kezai Shimbun survey. Manufacturing was hit across the board, while the service industries -- and particularly securities firms -- showed some gains (see Table).

While this year's wage hike is at the top of the unions' agendas, it is not the only problem. The strong yen is forcing fundamental changes in the Japanese economy. First, there is more emphasis on service industries. White-collar fields and low-tech service industries, in particular, are not areas of union strength. Of even greater concern is the growth of foreign direct investment and the increasing use of foreign subcontractors. According to the Ministry of International Trade and Industry, investment in foreign manufacturing facilities will grow at an annual rate of 14 percent in dollar terms through the end of this century, translating into a loss of 700,000-800,000 jobs. The Economic Planning Agency estimates that Japanese foreign direct investment will create 1.2 million jobs abroad and reduce the number of domestic positions by about half that number by the year 2000. Estimates by private research firms are less dire but still predict job losses in the range of 500,000. Even the most optimistic of these forecasts would push unemployment up to 4 percent, forcing union leaders and government officials to begin planning now.

The current pressures are already changing labor-management relations by eroding Japan's much-vaunted lifetime employment system. The massive layoffs planned in mining, shipbuilding, steel and other heavy manufacturing industries will test the famed cooperative spirit, since many of those laid off cannot be retrained for high technology or service jobs. Although big companies are encouraging older workers to retire early and are shifting workers to subsidiaries and related firms, such measures are limited and temporary. It is not clear how companies and unions will meet this challenge. Some predict the end of peaceful relations, while others feel that the system will survive in a modified form. If the yen continues to rise, however, all bets are off.

Jon Choy

Initial Survey of Winter Bonuses, 1986

(pre-tax, weighted average bonus in yen)

Industry	Number of firms	Bonus	Change
Energy	29	Y630,900	3.98%
Metals	61	507,687	-5.56
Chemicals	92	601,559	0.11
Textiles, paper and pulp	31	596,470	1.59
Food products	66	642,609	1.88
Electronics	118	544,495	-4.51
Electric and nonelectric machinery	149	564,785	-3.17
Motor vehicles	80	597,638	0.84
Shipbuilding and defense	20	469,724	-7.99
Transportation and warehousing	49	634,991	4.80
Construction, housing and real estate	101	608,882	0.89
Services, leisure and fashion	39	588,922	2.38
Information	48	764,722	1.06
Trading companies	10	707,719	2.86
Retail companies	39	558,682	4.30
Securities companies	7	835,293	13.52
All industries	939	582,103	0.83
Settled as of November 26	804	579,838	0.65

Source: Nihon Keizai Shimbun

Big Profits For Securities Firms

Amidst the complaints about the adverse impact of the strong yen by Japan's export-oriented firms, Japanese securities traders are trumpeting a year of record profits. Financial liberalization, ample amounts of underutilized funds, exchange-rate fluctuations and the heightened interest of Japanese investors in foreign investments have all worked to the advantage of the financial middlemen.

Tokyo's financial liberalization program has opened new markets for securities dealers, particularly the Euroyen market and the bond futures market. The market for Euroyen bonds now rivals that of bonds denominated in Deutsche marks. The total amount floated in 1986 was somewhere in the neighborhood of $12 to $16 billion, far ahead of 1985's $6.5 billion total. The bond futures market, which opened in October 1985, was the biggest in the world in terms of volume in 1986, trading contracts worth Y1,870 trillion ($12.1 trillion at Y155=$1.00). In addition, 1986's two-way trade in bonds probably totaled over $2 trillion, easily outdistancing 1985's $13 billion level.

Financial liberalization has also injected vitality into existing domestic markets. Although securities companies faced greater competition for investor funds from banks, which offered several new instruments, there was plenty to go around. Corporations and individuals flush with cash became much more daring in their financial planning -- zaitech or "financial technology" was the buzzword -- and securities companies naturally benefited. The Tokyo Stock Exchange boomed, adding strength to the fundamental securities business. The Nikkei average started last year at around 13,000 and rose to almost 19,000 by year's end. The index reached a record 19,554.72 on January 26 and market watchers predict that the 20,000 barrier will be broken this year.

Foreign markets and foreign investments are taking on greater importance as Japan integrates its economy in global financial markets. The yen's appreciation and large cash reserves have made major Japanese institutions instant stars on international markets. In addition to the Euromarket, securities firms have increased their presence in the United States. In fact, their expansion has been so rapid that it has generated some backlash among American financial institutions.

All this activity added up to record profits (see Table). At the end of their fiscal year (September), unconsolidated pre-tax profits of the Big Four brokerage houses (Daiwa Securities Co., Ltd., Nikko Securities Co., Ltd., Nomura Securities Co., Ltd. and Yamaichi Securities Co., Ltd.) reached Y986.6 billion ($6.4 billion). The Big Four's overseas subsidiaries have just reported pre-tax profits totaling Y83.3 billion ($537.4 million) for the same period, 2.3 times their 1985 showing.

Pre-Tax Profits of Japan's Major Securities Firms, FY 1986

(year ending September in billions of yen)

	Parent Company			Foreign Subsidiaries		
	FY 1985	FY 1986	Change	Number	FY 1986 Profits	Change
Nomura Securities Co., Ltd.	Y210.2	Y389.5	85.3%	10	Y38.2	110%
Daiwa Securities Co., Ltd.	122.9	232.5	89.2	7	20.8	170
Nikko Securities Co., Ltd.	112.5	195.8	74.1	8	12.5	130
Yamaichi Securities Co., Ltd.	103.5	168.8	63.2	11	11.8	150

Source: Nihon Keizai Shimbun

Nomura, the biggest of the group, reported that its London affiliate, Nomura International Ltd., saw earnings jump 170 percent to Y12 billion ($77.4 million). Nomura Securities International Inc., based in New York, raked in Y4.5 billion ($29 million) in pre-tax profits, a gain of 90 percent. And Nomura International (Hong Kong) Ltd. reported an 80 percent increase in profits to Y9.1 billion ($58.7 million). Not surprisingly, the overseas offices of the Big Four reported a 50 percent gain in employment to handle the surge in business. It is clear that international markets are becoming more important to Japanese financial institutions and vice versa.

Jon Choy

Agricultural Reform In The Offing?

Despite the outcry precipitated in Japan by the Rice Miller Association's attempt to force the country to overhaul its rice program (see JEI Report No. 33B, September 12, 1986), there appears to be increasing debate over the need to reform the agricultural sector and adjust government policies accordingly. Several arguments have been offered in favor of reform. First is the simple matter of costs. With the successful conclusion of the cabinet's administrative reform drive, agriculture is one of the few areas in which the government may be able to reduce financial burdens in the name of economic efficiency. With the ruling Liberal Democratic Party apparently gaining voting strength in urban areas, reform proponents argue that gradually reducing payments to farmers and easing import restrictions would moderate food costs for urban constituents while allowing sufficient time for farm interests to adjust. It would also reduce the government's huge outlays and conform to the Ministry of Finance's long-term fiscal reconstruction plans.

Agricultural reform clearly is the most explosive political issue in Japan. Despite the LDP's new strength, the party still relies on rural voters for support and must be careful not to alienate them. Even opposition parties have made appeals to rural voters by proposing "food security" planks in their political platforms. Nevertheless, the reform debate has continued, spurred in some respects by the rice millers' petition. Some press reports have alluded to proposals to increase dramatically quotas on such contentious products as beef and citrus. While many of these reports may be premature, their regularity suggests that a long consensus-building process concerning agricultural imports may be under way.

Should policymakers opt for significant reforms, however, the process would be gradual. Quota increases, for example, most likely would be negotiated within a multilateral context rather than with specific trading partners. Any reductions in government subsidies or import liberalization moves would be phased in over several years to minimize disruptions to the agricultural sector. In short, it is unlikely that a foreign government would have much to gain by making the issue a political hot potato since no one administration is likely to remain in office long enough to take credit for any changes. Nevertheless, from a long-term economic and political perspective, the rumblings at the moment may be the beginning of a transformation as significant to Japan as any of the government reforms of the previous half decade.

Michael W. Chinworth

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REPORT

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U.S.-JAPAN COMPETITION IN CONSTRUCTION

Summary

Tokyo's willingness to allow American construction companies to bid on the huge Kansai International Airport project is being billed in Washington as a litmus test of the government's commitment to open Japanese markets to foreign competition. U.S. contractors have a lot riding on the results of this test since it will determine whether they can compete for the vast amount of new business generated by other big public works projects. But with few other growth markets at home and limited opportunities for more overseas work, Japanese construction companies are not anxious to share these contracts with their struggling American counterparts. What U.S. government and industry officials find particularly troublesome about this attitude is that Japanese contractors are winning an increasing number of contracts in this country, including some public works projects.

Looking for Business

Construction has become the latest battleground in the Reagan administration's fight to win expanded market opportunities in Japan for American businesses. Assistant Secretary of Commerce for Trade Development H.P. Goldfield has spearheaded a year-long drive for changes in the system used to award public works contracts, arguing that it prevents foreign architectural, engineering and construction companies from competing for prime contracts no matter how extensive their experience and expertise. At the heart of this campaign is the designated bidder system, in which a contracting agency invites registered companies to submit qualifications and proposals for particular parts of its project and then compiles a short list of finalists that can bid on the contract. For frustrated U.S. government and industry officials, this procurement process shouts "no foreigners need apply."

The immediate target of Washington's demand for open and transparent bidding procedures is Kansai International Airport -- a Y1 trillion ($6.7 billion at Y150=$1.00) project to build a state-of-the-art facility on a manmade island in Osaka Bay. By mid-1986 U.S. trade policymakers had reluctantly accepted the fact that foreign firms would not be allowed to participate as prime contractors on the lucrative civil engineering part of the project because beginning the bidding process all over again would seriously delay the start of construction, then scheduled for the end of the year. But they continue to press Kansai International Airport Co., Ltd., the quasi-governmental organization in charge of the project, to switch to open international bidding procedures for contracts to supply machinery and services for first-phase work, which includes construction of the offshore island, seawalls and a connecting bridge. Competitive bidding is also being pushed for the project's second stage -- the construction of runways, aprons, terminals and other buildings -- and its third phase -- the purchase of navigational systems and other equipment.

The White House has invested more than the usual amount of political capital in its campaign to win American companies the right to compete for Kansai airport contracts. The obvious reason is that administration officials believe they have prima facie evidence of discrimination against firms considered to be in the forefront of airport construction technology. But there is a more basic explanation. Kansai airport is just one of perhaps a dozen huge Japanese public works projects scheduled for completion by the turn of the century. If U.S. contractors are given the chance to bid on that project, Washington reasons, they will be positioned to compete successfully on such upcoming projects as the Y1.15 trillion ($7.7 billion) bridge and tunnel across Tokyo Bay and the Y2 trillion ($13.3 billion) expansion of the Port of Yokohama.

For U.S. construction companies, which say they have been trying to participate in the Kansai project for at least five years, the mammoth Japanese public works projects coming up for bid are one of the few bright spots in an otherwise gloomy outlook. New construction business at home is expected to decline in the late 1980s, a casualty of sluggish economic growth, cutbacks in government spending, the loss of investor tax incentives and a still big U.S. trade deficit. Among the hardest-hit markets could be two of the props of the 1983-86 expansion in domestic contract awards -- transportation and commercial work. Less federal aid for highway and bridge construction and repair is taken as a given, while commercial work, particularly office construction, will be hobbled by overbuilding in the mid-1980s and tax reform.

Increased funding for water projects could take up some of the slack in public works contracts caused by the slowdown in the transportation market, but that is one of the few offsets industry executives and analysts anticipate. The new tax bill has killed any chance of a near-term turnaround in the market

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Table 1A: Top American Contractors, 1981-85*

(in millions of dollars)

	1981		1982		1983		1984		1985	
	Total	Foreign	Total	Foreign	Total	Foreign	Total	Foreign	Total	Foreign
Parsons Corp.	$10,244.0	$3,654.0	$4,319.7	$3,074.4	$6,627.7	$4,160.7	$7,514.7	$3,010.2	$8,620.0	$5,027.1
Bechtel Group Inc.	10,114.0	6,923.0	5,490.0	3,866.0	13,810.0	7,884.0	8,220.0	4,905.0	7,364.0	3,626.0
M.W. Kellogg Co.**	6,700.0	3,700.0	8,200.0	5,000.0	8,500.0	5,000.0	10,855.0	8,630.0	6,757.0	6,204.0
Morrison Knudsen Corp.	5,535.7	3,205.4	3,104.4	1,325.8	2,003.4	74.4	2,086.7	463.5	5,887.7	418.2
Brown & Root Inc.	10,738.0	2,642.0	2,472.9	1,250.1	2,059.4	769.2	3,883.9	1,288.7	5,578.7	2,928.7
Fluor Corp.	10,600.0	4,200.0	6,507.1	4,097.3	2,605.0	1,193.0	8,353.3	1,527.8	5,127.5	1,392.3
Rust International Corp.**	--	--	--	--	--	--	--	--	5,097.9	94.5
Lummus Crest Inc.	4,600.0	2,693.0	3,252.0	2,392.0	2,460.0	1,720.0	3,200.0	2,300.0	3,500.0	2,420.0
Stearns Catalytic Corp.***	3,556.5	698.0	4,045.0	384.0	3,118.6	791.2	4,932.3	549.4	3,118.9	473.0
Ebasco Services Inc.	3,416.1	420.1	2,880.6	508.4	2,072.4	54.1	1,580.5	134.5	2,751.9	62.1

Table 1B: Top Japanese Contractors, 1981-85*

(in millions of dollars)

	1981		1982		1983		1984		1985	
	Total	Foreign	Total	Foreign	Total	Foreign	Total	Foreign	Total	Foreign
Kajima Corp.	$4,494.0	$252.0	$4,352.8	$363.8	$3,840.1	$291.1	$3,787.0	$485.0	$4,953.4	$627.7
Shimizu Construction Co., Ltd.	4,220.4	220.4	4,379.9	471.9	4,299.5	537.0	3,931.7	345.9	4,779.1	605.4
Kumagai Gumi Co., Ltd.	2,899.8	216.9	3,115.3	550.3	3,283.5	737.1	3,227.7	850.2	4,692.2	2,175.8
Tasei Corp.	4,521.0	485.0	4,067.0	481.0	4,834.0	453.0	4,213.0	247.0	4,641.3	266.5
Mitsubishi Heavy Industries, Ltd.	n.a.	801.6	n.a.	n.a.	n.a.	195.0	3,800.0	720.0	4,410.0	1,425.0
Ohbayashi Corp.	n.a.	n.a.	n.a.	n.a.	3,378.8	375.4	3,122.5	359.9	4,280.0	377.8
Takenaka Komuten Co., Ltd.	n.a.	n.a.	3,043.8	311.4	3,101.3	304.4	3,011.8	191.5	3,787.0	189.0
Hazama-Gumi Ltd.	n.a.	n.a.	n.a.	66.9	1,841.5	346.5	1,855.0	319.1	2,266.3	499.8
Fujita Corp.	1,929.0	216.0	n.a.	n.a.	n.a.	n.a.	1,611.7	81.7	1,980.0	83.0
Sato Kogyo Co., Ltd.	1,397.7	123.6	n.a.	n.a.	1,172.9	134.2	1,219.6	113.6	1,913.2	121.1

* Listed in terms of total 1985 contracts.

** In 1985 Kellogg Rust Inc. was split into its two operating units, M.W. Kellogg Co. and Rust International Corp. The contracts won by Kellogg Rust in the 1981-84 period are listed under M.W. Kellogg.

*** Stearns Catalytic Corp. was formed in 1981 through the merger of Stearns-Roger Engineering Corp. and Catalytic Inc. The 1981 figure for Stearns Catalytic reflects the contracts won by the two separate companies.

Note: Figures include prime contracts, shares of joint ventures, subcontracts, design-construct contracts and construction management contracts where the firm is exposed to financial liability similar to a general contractor (greater than $500,000). Design-construct contracts are based on the erected value of the plant, including installed equipment. Construction management contracts are based on the erected value of the project managed.

Source: Engineering News-Record and International Construction Week. Used with permission.

for multifamily housing, for example. Meanwhile, new industrial and process plant contracts are expected to remain limited because of the U.S. oil industry's troubles, the weak economy and the continuing trade problems of many manufacturing sectors.

To make matters worse, the prospects for new overseas work -- the bread and butter of many of the U.S. construction industry's heavyweights (see Table 1A) -- remain bleak. Foreign business has been on the skids for five years, with 1985 contract awards adding up to only about half of 1981's record total (see Table 2). The causes of this contraction are straightforward. For starters, the drop in oil prices has forced governments in the Middle East, the biggest market for international contractors, to scale back their ambitious building plans for both infrastructure and process plants. Similarly, the enormous financial problems of Latin American countries have led to the near-collapse of new contract awards there, whether for public works projects or natural resource processing plants. At the same time, generally slow growth in Europe and Canada has made other industrial countries weak markets for U.S. construction companies.

Table 2: Contracts Won by Top 400 U.S. Construction Companies, 1981-85

(in millions of dollars)

	1981	1982	1983	1984	1985
Total	$162,800	$128,491	$118,074	$131,228	$136,119
Domestic	109,169	83,223	88,288	100,328	107,131
Foreign	53,631	45,268	29,786	30,899	28,988
Middle East	15,296	18,383	12,754	10,694	7,805
Africa	3,791	2,872	2,463	1,682	4,281
Europe	7,532	6,902	4,724	5,473	4,327
Asia	10,436	8,923	4,949	8,832	7,803
Latin America	10,950	4,491	1,739	1,639	2,266
Canada	5,626	3,697	3,156	2,579	2,505

Source: Engineering News-Record. Used with permission.

Asia (including Australia) was the only region where business held up fairly well for American contractors in the first half of the decade. It is also the region with the greatest potential for growth. But this prospect is generating the same fierce competition for work from international rivals that U.S. construction firms have increasingly encountered in other markets since neither European nor Asian contractors have been much more successful in bucking the post-1981 slide in new worldwide contract awards than domestic companies. For U.S. contractors active overseas, therefore, the ever-tougher battle for new work represents a one-two blow to future corporate earnings: thinner profit margins on fewer foreign contracts, forcing companies to pare margins to win business at home in a market that just managed to regain its 1981 size last year and is now headed back down.

Table 3: Top International Contractors, 1981-85*

(in millions of dollars)

1985 Rank	Company	Country	1981		1982		1983		1984		1985	
			Foreign	Total	Foreign	Total	Foreign	Total	Foreign	Total	Foreign	Total
1	M.W. Kellogg Co.**	United States	$3,700.0	$6,700.0	$5,200.0	$8,200.0	$5,000.0	$8,500.0	$8,630.0	$10,855.0	$6,204.0	$6,757.0
2	Parsons Corp.	United States	3,654.0	10,244.0	3,074.4	4,319.7	4,160.7	6,627.7	3,010.2	7,514.7	5,027.1	8,620.0
3	Bechtel Group Inc.	United States	6,923.0	10,114.0	3,866.0	5,490.0	7,884.0	13,810.0	4,905.0	8,220.0	3,626.0	7,364.0
4	Brown & Root Inc.	United States	2,642.0	10,738.0	1,250.1	2,472.3	769.2	2,059.4	1,288.7	3,883.9	2,928.7	5,578.7
5	Lummus Crest Inc.	United States	2,693.0	4,600.0	2,392.0	3,252.0	1,720.0	2,460.0	2,300.0	3,200.0	2,420.0	3,500.0
6	Kumagai Gumi Co., Ltd.	Japan	216.9	2,899.8	550.3	3,115.3	737.1	3,283.5	850.2	3,227.7	2,175.8	4,692.2
7	Hyundai Engineering & Co., Ltd.	Korea	2,386.0	3,016.2	2,920.5	3,422.7	1,109.0	1,606.2	2,490.6	3,016.8	1,998.1	2,536.4
8	Philipp Holzmann AG	West Germany	3,726.0	5,390.0	3,223.7	4,864.4	1,755.1	3,657.1	1,931.3	3,291.3	1,948.2	3,232.5
9	SADE/SADELMI Group of Cos.	Italy	2,705.0	2,720.0	3,242.0	3,246.0	2,003.0	2,021.0	1,773.0	1,784.0	1,795.4	1,799.0
10	John Brown Engineers & Constructors	England	360.0	404.0	n.a.	n.a.	641.0	2,739.0	1,329.0	1,567.0	1,743.0	2,066.0
11	Davy Corp. plc	England	5,015.0	5,045.6	3,380.4	3,429.6	2,036.3	2,178.6	1,553.4	1,627.4	1,611.3	2,118.8
12	Foster Wheeler Corp.	United States	3,450.0	4,400.0	2,500.0	3,200.0	2,103.0	2,980.0	1,933.0	2,413.0	1,426.0	2,048.0
13	Mitsubishi Heavy Industries, Ltd.	Japan	801.6	n.a.	n.a.	n.a.	195.0	n.a.	720.0	3,800.0	1,425.0	4,410.0
14	Fluor Corp.	United States	4,200.0	10,600.0	4,097.3	6,507.1	1,193.1	2,605.1	1,527.8	8,353.3	1,392.2	5,127.4
15	IMPRESIT SpA	Italy	2,052.0	2,757.0	1,631.6	1,914.7	1,652.8	1,805.2	860.0	1,210.4	1,345.9	1,632.4
16	Bouygues	France	n.a.	n.a.	560.0	2,122.0	1,100.0	2,320.0	1,000.0	2,700.0	1,250.0	3,050.0
17	Spie Batignolles	France	1,543.7	2,306.7	1,070.0	2,074.3	1,092.3	1,825.2	1,101.6	1,826.0	1,212.3	2,442.6
18	Italimpianti SpA	Italy	248.2	289.9	334.5	409.1	55.0	130.2	153.8	256.7	1,170.5	1,389.0
19	Societe Auxiliare d'Entreprises	France	990.0	2,180.0	1,505.0	2,808.0	1,446.0	2,487.0	660.0	1,454.0	1,164.0	2,501.0
20	Enka Construction & Industry Co., Inc.	Turkey	743.0	1,007.0	1,129.7	1,405.8	1,595.0	1,869.8	1,347.4	1,655.3	1,081.6	1,572.5
21	JGC Corp.	Japan	699.3	893.8	2,480.7	3,069.5	642.0	990.0	519.0	771.0	1,020.1	1,420.2
22	Daewoo Corp.	Korea	2,077.0	2,360.4	533.8	911.3	891.3	1,266.8	677.0	1,056.0	921.4	1,208.4
23	Saipem SpA	Italy	448.0	n.a.	304.2	n.a.	747.0	835.0	532.9	561.1	826.2	909.9
24	Chiyoda Chemical Engineering & Construction Co., Ltd.	Japan	711.1	1,433.6	1,118.0	1,391.0	991.0	1,218.0	350.0	616.0	801.0	1,161.0
25	Voest-Alpine AG	Austria	n.a.	n.a.	1,000.0	1,170.0	430.0	472.0	622.3	656.3	783.8	896.0

* Ranked in terms of foreign contracts won in 1985.

** In 1985 Kellogg Rust Inc. was split into its two operating units, M.W. Kellogg Co. and Rust International Corp. The contracts won by Kellogg Rust in the 1981-84 period are listed under M.W. Kellogg.

Note: Figures include prime contracts, shares of joint ventures, subcontracts, design-construct contracts and construction management contracts where the firm is exposed to financial liability similar to a general contractor (greater than $500,000). Design-construct contracts are based on the erected value of the plant, including installed equipment. Construction management contracts are based on the erected value of the project managed.

Source: Engineering News-Record and International Construction Week. Used with permission.

More often than not, American contractors are losing business to their traditional rivals, the Europeans. In fact, European construction companies won more new work overseas in the 1981-85 period than U.S. firms did. This enabled them to nail down 11 of the top 25 positions on Engineering News-Record's 1985 list of the world's 250 leading international contractors compared with 7 for the United States (see Table 3).

Domestic industry executives point out that with many developing countries in a precarious financial position, technical and managerial expertise and cost competitiveness often take a backseat in contract awards to the ability to arrange attractive project financing. These conditions of competition, it is argued, favor European contractors as well as Japanese and Korean companies: they are able to tap lower-cost commercial bank loans and/or their governments are willing to provide credits on terms that frequently circumvent the Organization for Economic Cooperation and Development's "gentlemen's agreement" on export financing.

Trying to Keep Business

Japanese contractors are also banking on big-ticket public works projects like Kansai airport and the trans-Tokyo Bay project to carry them through the lean times anticipated in several key domestic markets. Double-digit increases in capital spending by manufacturers and service-industry companies alike in both 1984 and 1985 translated into back-to-back record volumes of contract awards for Japanese construction companies (see Table 4). Moreover, preliminary data indicate that 1986 was another banner year for the industry, thanks largely to increased investment by electric utilities and gas companies -- the main beneficiaries of the strong yen, more institutional (hospitals, for example) and leisure-industry contracts, and steady office and retail construction work. But with most signs pointing to slower economic growth in the late 1980s, analysts question whether the nonmanufacturing sector will maintain its strong investment pace. Any cutback, they warn, would make it hard for contractors to offset the drop in new business in the manufacturing sector, which continues to scale back spending plans in the face of the appreciating yen, and what appears to be another plateau in residential construction work.

Construction firms in Japan are actually in a double bind since they can no longer count on an increase in overseas work. While U.S. contractors were watching their new foreign business shrink in the mid-1980s, Japanese builders managed to win a steady stream of contract awards abroad (see Table 5). Their strategy was deceptively simple: to move aggressively into the United States and Australia -- two growth markets where they had previously done little work -- as developing country markets began to contract. This reorientation has helped the industry maintain a big backlog of work, but it has not improved the profit picture for Japan's five biggest contractors (see Table 6). If anything, analysts say, the expansion into this country and Australia has added to the drain on earnings caused initially by cutthroat international competition for contracts in the Third World.

Now Japanese construction companies face the same gloomy outlook for foreign business as their American counterparts. In fact, their medium-term prospects are probably worse since the strong yen puts the Japanese industry at

Table 4: Contract Awards in Japan, 1981-85*

(in billions of yen**)

	1981	1982	1983	1984	1985
Total	Y9,674.4	Y9,512.3	Y9,547.0	Y11,493.6	Y12,157.6
By sector					
Public sector	3,531.6	3,398.7	3,259.9	3,468.5	3,370.3
Private sector	5,408.9	5,272.1	5,363.8	6,733.4	7,430.7
By type of work					
Building	5,722.5	5,593.9	5,712.8	7,034.3	7,577.6
Offices and stores	1,707.9	1,734.6	2,101.8	2,255.1	2,786.3
Factories, warehouses and power stations	1,004.8	981.3	915.2	1,390.2	1,330.2
Residential	1,034.3	1,063.7	973.6	1,362.9	1,453.7
Schools, hospitals and public offices	1,376.0	1,216.9	1,146.1	1,327.6	1,261.6
Other	599.6	597.3	576.1	698.5	745.9
Civil engineering	3,951.9	3,918.3	3,834.2	4,459.3	4,580.1
Dams	341.6	295.5	337.4	313.3	288.5
Flood control	105.1	138.7	114.7	164.2	123.8
Water works and sewage	635.3	578.9	546.7	675.9	647.1
Railroads	414.3	420.6	410.7	347.0	343.6
Ports	305.7	311.4	259.2	249.0	283.4
Highways and bridges	573.0	593.4	665.7	808.4	854.8
Land development	474.0	467.5	430.7	495.7	630.5
Electricity, gas and communications	418.5	386.4	394.4	432.4	431.4
Other	684.5	725.9	674.6	973.4	977.0

* Prime contracts won by 43 major construction companies in the 1981-82 period and by 50 big contractors in the 1983-85 period.

** The yen figures can be converted to dollars using the following average annual exchange rates: 1981, Y220.54; 1982, Y249.08; 1983, Y237.51; 1984, Y237.52; and 1985, Y238.54.

Source: Ministry of Construction

a competitive disadvantage, particularly when industrial and process plant contracts are up for bid. Sketchy information suggests that Japanese contractors are already feeling the triple blow of declining new construction business both here and in third markets, increased competition for what new work there is, and the yen's appreciation. No one in the industry expects the value of FY 1986 foreign contracts to be off by as much as the 48.4 percent plunge in April-June 1986 awards, but a 25 percent drop accompanied by another decline in profits would come as little surprise.

Although cold comfort to corporate executives, Japanese contractors are in a better position to weather the downturn in the international construction

Table 5: Foreign Contracts Won by Japanese Construction Companies, FY 1981-FY 1985*

(in millions of yen**)

	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985
Total	Y712,758	Y921,556	Y1,014,000	Y935,027	Y1,029,648
Parent companies	629,587	770,663	848,420	736,960	859,217
Overseas affiliates	83,171	150,894	165,581	198,067	170,431
By region					
Asia	437,345	696,427	675,720	501,730	396,175
Middle East	191,022	118,324	163,271	75,738	55,275
Africa	16,520	9,594	10,683	3,402	22,775
North America	21,814	33,266	83,250	207,122	268,538
Latin America	40,547	33,459	14,657	22,421	51,598
Western Europe	2,882	8,228	7,231	9,540	16,804
Eastern Europe	90	13,550	0	0	16,370
Oceania	2,538	8,708	59,188	115,074	202,113
By type of work					
Landfill	34,740	53,719	80,278	16,671	28,072
Ports	37,446	49,377	10,805	18,176	29,937
Railroads	68,074	118,592	60,676	58,165	45,610
Highways	26,044	68,634	49,432	46,132	8,228
Airports	2,793	1,377	12,989	21,009	3,410
Industrial plants	39,463	37,071	92,046	44,782	66,339
Power plants	26,769	100,371	147,978	48,410	40,078
Dams	13,026	6,769	17,688	5,000	31,982
Water works	22,563	30,280	16,927	19,760	11,753
Public construction	218,708	176,676	134,515	157,689	57,877
Commercial construction	85,560	154,279	215,913	288,336	496,905
Urban development and other	69,074	22,046	46,934	40,827	91,101

* Contracts won by the 57 members of the Overseas Construction Association of Japan, Inc. Contract amounts exclude equipment costs.

** The yen figures can be converted to dollars using the following average annual exchange rates: FY 1981, Y227.52; FY 1982, Y249.64; FY 1983, Y236.33; FY 1984, Y244.19; and FY 1985, Y221.09.

Source: Overseas Construction Association of Japan, Inc.

business than American companies since they have always been less dependent on foreign contracts for new work than most of their major rivals (see Table 1B). Even in 1985, their peak year for foreign contract awards, Japanese construction firms generated only 19.5 percent of their new business overseas, according to Engineering News-Record's survey. The comparable figure for U.S. contractors was 38.4 percent, while for European builders it ranged anywhere from 45 to 80 percent.

Table 6: Financial Profiles of Japan's Top Contractors

(in millions of yen*)

	Total Revenues	Pre-Tax Profits	Source of Revenues		
			Building	Civil Engineering	Real Estate
Shimizu Construction Co., Ltd.					
FY 1981	Y776,990	Y36,446	75%	24%	1%
FY 1982	871,854	36,462	75	24	1
FY 1983	964,131	36,672	81	18	1
FY 1984	923,544	31,852	79	19	2
FY 1985	1,052,293	28,370	78	19	3
Kajima Corp.**					
FY 1981	863,125	41,222	59	37	-
FY 1982	942,592	38,621	64	33	-
FY 1983	932,062	27,668	62	33	-
FY 1984	913,628	27,108	61	34	-
FY 1985 (projected)	990,000	27,000	n.a.	n.a.	n.a.
Taisei Corp.					
FY 1981	811,667	33,202	67	30	3
FY 1982	845,461	33,465	73	26	2
FY 1983	907,700	31,128	70	29	1
FY 1984	968,322	28,350	70	27	3
FY 1985	978,607	23,058	73	25	2
Kumagai Gumi Co., Ltd.***					
FY 1981	607,197	34,364	49	49	2
FY 1982	631,417	34,509	46	48	6
FY 1983	614,485	30,059	47	46	7
FY 1984	709,863	32,559	47	43	10
FY 1985	841,000	28,372	n.a.	n.a.	n.a.
Ohbayashi Corp.					
FY 1981	681,594	24,667	61	35	4
FY 1982	644,726	25,802	66	32	2
FY 1983	689,883	25,918	64	34	2
FY 1984	766,318	22,514	64	32	4
FY 1985	797,786	20,415	70	26	4

* The yen figures can be converted to dollars using the following average annual exchange rates: FY 1981, Y227.52; FY 1982, Y249.64; FY 1983, Y236.33; FY 1984, Y244.19; and FY 1985, Y221.09.

** Year ending in November.

*** Year ending in September.

Source: Toyo Keizai Shinposha, Japan Company Handbook

The flip side of the Japanese number is what is important to industry officials since it highlights the fact that Japanese construction companies have climbed up the list of the world's top contractors largely on the strength of new business at home (see Appendix). They are obviously not anxious to share this business with foreign competitors, particularly if the work in question -- Kansai airport and other mammoth public works programs -- represents their one certain source of future contracts.

The Other Controversy

What American industry and government officials find most frustrating about the reluctance of Japanese contractors to compete in their home market with foreign builders is that these same companies are rapidly expanding their U.S. presence. According to data compiled by Engineering News-Record's International Construction Week, Japanese construction firms won contracts worth $1.8 billion in this country in 1985 -- a jump of 168.5 percent in just one year and a far cry from the $100 million or so in new work they found here in 1982. No figures are yet available for 1986, but market watchers conservatively estimate that Japanese contractors did $3 billion worth of business. Whatever the final number, it will add fuel to the controversy over the U.S. activities of Japanese construction companies.

Leaving aside the question of unequal market access -- admittedly a difficult thing to do in the current environment, it is hard to figure out why the increased work being done by Japanese contractors in this country has triggered as much controversy as it has. After all, their 1985 contract volume represented just 1.1 percent of all new construction business in the United States. Even if 1986 contracts added up to more than $3 billion, they would still equal only 2 percent-plus of total awards.

What's more, Japanese companies are not the biggest foreign contractors in this country; European builders are, but their work is less visible since it is conducted mainly through acquired American construction firms. For example, West Germany's Philipp Holzmann AG owns the Jones Group Inc., the 15th-biggest U.S. contractor in 1985 with $1.6 billion in awards, while Bilfinger + Berger Bau AG is the parent of 40th-ranked Fru-Con Corp., which had nearly $0.6 billion in new construction work in 1985. At least three major French contractors have also used acquisitions to expand their U.S. business, as have several other leading European firms.

Japanese construction companies have rejected the takeover route, opting instead to build their U.S. business from scratch. Kajima Corp., the parent of Kajima International Inc., which ranked 68th on Engineering News-Record's 1985 list of the top 400 American contractors with a contract volume of $314.5 million, has been working in this country since 1964, while Ohbayashi Corp. established an American subsidiary in 1972. Most of Japan's other big contractors have been here for at least 10 years. They feel they have paid their dues and are entitled to whatever work they can win.

Most of this work still comes from Japanese companies. International Construction Week estimated, for example, that $1.3 billion of the $1.8 billion worth of new business reported by Japanese contractors in 1985 was awarded by Japanese clients, including institutional investors that regard commercial and residential buildings in the United States as good investments as well as manufacturers establishing production facilities here or expanding their U.S. sales operations.

The record number of Japanese-owned manufacturing companies set up in this country during 1985 (see JEI Report No. 13A, April 4, 1986) generated $550 million in new business for Japanese contractors, ICW calculated. Roughly four-fifths of this total was for automotive assembly plants, as Mazda Motor Corp., Mitsubishi Motors Corp. and Toyota Motor Corp. broke ranks with Honda Motor Co., Ltd. and Nissan Motor Co., Ltd. -- the first two Japanese motor vehicle makers to establish a U.S. production base -- and selected Japanese companies to build their American factories. Kajima won the contract to design and build both the Mazda plant, located in Flat Rock, Michigan, and the Bloomington-Normal, Illinois facility of Diamond-Star Motors Corp., a joint venture between Mitsubishi and Chrysler Corp., while Ohbayashi got the contract to construct Toyota's factory in Georgetown, Kentucky.

Office and plant contracts from Japanese manufacturers have always been the staple work of Japanese builders operating in the United States, but commercial and residential development projects for both Japanese investors and American clients are the major source of new business for most companies. Kumagai Gumi Co., Ltd., for example, jumped to the top of the list of Japanese construction firms reporting new U.S. work in 1985 by signing development contracts worth $574 million, including $336 million for the construction and renovation of three luxury hotels in Hawaii and $193 million for the construction of three mixed-use high-rise buildings in Manhattan.

Ohbayashi and one or two other Japanese contractors have branched out in a different direction, competing for public works contracts. Ohbayashi has been awarded 10 government-funded projects, mostly for tunnels, although in 1985 it won a $63 million Corps of Engineers contract for a dam in Oregon. For obvious reasons these awards have provoked the loudest outcry from the U.S. construction industry. But these complaints ignore a fundamental fact. Whether the Japanese project is a dam, an office building or a manufacturing facility, all of the actual construction work is subcontracted to American companies. Put another way, Japanese contractors working in the United States play the same role in a project as their American counterparts -- construction manager and general contractor.

The Two Controversies Meet

Although American contractors are the main beneficiaries of the fast-expanding volume of construction contracts won by Japanese companies, industry executives continue to call on Washington to retaliate against Japan for its failure to adopt competitive bidding procedures for the Kansai airport project. These calls have found a receptive audience at both ends of Pennsylvania Avenue, but threats of retaliation by Reagan administration trade negotiators and Sen. Frank Murkowski (R, Alaska) have done little to change attitudes in Japan. After nearly a year of bilateral discussions, most recently in late January, Kansai officials still take the contradictory position that foreign companies can compete for prime contracts but that the designated bidder system will not be abandoned.

Tokyo bought itself some time January 29 when government officials revealed that Caterpillar Tractor Co. had received an $86.7 million contract to supply large earthmoving machines. But Japan is not off the hook. While applauding the Caterpillar contract and three smaller awards to American companies, U.S. trade negotiators reiterated that "token" contracts such as these are not sufficient. In short, construction will remain a flash point in bilateral relations until Kansai authorities award several major contracts to U.S. firms.

For further information, contact Susan MacKnight

* * * * * *

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix: World's Top Contractors, 1981 and 1985

(in millions of dollars)

1981			1981	
Rank		Country	Total	Foreign
1	Brown & Root Inc.	United States	$10,738.0	$2,642.0
2	Fluor Corp.	United States	10,600.0	4,200.0
3	Parsons Corp.	United States	10,244.0	3,654.0
4	Bechtel Group Inc.	United States	10,114.0	6,923.0
5	Kellogg Rust Inc.	United States	6,700.0	3,700.0
6	Morrison Knudsen Co., Inc.	UnitedStates	5,535.7	3,205.4
7	Philipp Holzmann AG	West Germany	5,390.0	3,726.0
8	Davy Corp. plc	England	5,045.6	5,015.0
9	Lummus Group, Inc.	United States	4,600.0	2,693.0
10	C.F. Braun & Co.	United States	4,546.0	4,438.0
11	Taisei Corp.	Japan	4,521.0	485.0
12	Kajima Corp.	Japan	4,494.0	252.0
13	Foster Wheeler Corp.	United States	4,400.0	3,450.0
14	Shimizu Construction Co., Ltd.	Japan	4,220.4	220.4
15	Construtora Mendes Junior SA	Brazil	3,895.0	1,880.0
16	Ebasco Services Inc.	United States	3,416.1	420.1
17	Jacobs Engineering Group Inc.	United States	3,244.8	706.8
18	Hyundai Engineering & Construction Co., Ltd.	Korea	3,016.2	2,386.0
19	Dravo Corp.	United States	2,953.0	1,042.4
20	Kumagai Gumi Co., Ltd.	Japan	2,899.8	216.9
21	Guy F. Atkinson Co.	United States	2,842.0	1,982.2
22	IMPRESIT SpA	Italy	2,757.0	2,052.0
23	SADE/SADELMI Group of Cos.	Italy	2,720.0	2,705.0
24	Stone & Webster Engineering Corp.	United States	2,694.6	163.0
25	J.A. Jones Construction Co.	United States	2,632.8	26.1
26	Turner Construction Co.	United States	2,421.9	155.5
27	Daewoo Corp.	Korea	2,360.4	2,077.0
28	Spie Batignolles	France	2,306.7	1,543.7
29	Dumez	France	2,221.0	2,084.0
30	J. Ray McDermott Inc.	United States	2,202.4	995.6
31	Societe Auxiliare d'Entreprises	France	2,180.0	990.0
32	Hochtief AG	West Germany	2,120.0	1,170.0
33	Societe Generale d'Entreprises	France	2,066.0	1,336.0
34	Stearns-Roger Engineering Corp.	United States	1,988.5	40.0
35	Raymond International Inc.	United States	1,941.0	597.2
36	Fujita Corp.	Japan	1,929.0	216.0
37	Bilfinger + Berger Bau AG	West Germany	1,902.6	1,368.4
38	Ballast-Nedam Group N.V.	Netherlands	1,744.2	1,560.8
39	Grands Travaux de Marseille (GTM)	France	1,720.0	825.0
40	Burns & Roe Inc.	United States	1,687.8	493.2
41	Blount International Ltd.	United States	1,676.4	911.2
42	Daelim Industrial Co., Ltd.	Korea	1,672.4	1,374.8
43	Catalytic Inc.	United States	1,568.0	658.0
44	CBI Industries Inc.	United States	1,555.0	964.0
45	Austin Co.	United States	1,537.7	343.2

1985			1985	
Rank		Country	Total	Foreign
1	Parsons Corp.	United States	$8,620.0	$5,027.1
2	Bechtel Group Inc.	United States	7,364.0	3,626.0
3	M.W. Kellogg Co.	United States	6,757.0	6,204.0
4	Morrison Knudsen Corp.	United States	5,887.7	418.2
5	Brown & Root Inc.	United States	5,578.7	2,928.7
6	Fluor Corp.	United States	5,127.5	1,392.3
7	Rust International Corp.	United States	5,097.9	94.5
8	Kajima Corp.	Japan	4,953.4	627.7
9	Shimizu Construction Co., Ltd.	Japan	4,779.1	605.4
10	Kumagai Gumi Co., Ltd.	Japan	4,692.2	2,175.8
11	Taisei Corp.	Japan	4,641.3	266.5
12	Mitsubishi Heavy Industries, Ltd.	Japan	4,410.0	1,425.0
13	Ohbayashi Corp.	Japan	4,280.0	377.8
14	Takenaka Komuten Co., Ltd.	Japan	3,787.0	189.0
15	Lummus Crest Inc.	United States	3,500.0	2,420.0
16	Philipp Holzmann AG	West Germany	3,232.5	1,948.2
17	Stearns Catalytic Corp.	United States	3,118.9	473.0
18	Bouygues	France	3,050.0	1,250.0
19	Ebasco Services Inc.	United States	2,751.9	62.1
20	Hyundai Engineering & Construction Co., Ltd.	Korea	2,536.4	1,998.1
21	Societe Auxiliare d'Entreprises	France	2,501.0	1,164.0
22	Spie Batignolles	France	2,442.6	1,212.3
23	Turner Corp.	United States	2,440.8	56.3
24	Hazama-Gumi Ltd.	Japan	2,266.3	499.8
25	Stone & Webster Engineering Corp.	United States	2,262.6	349.4
26	Davy Corp. plc	England	2,118.8	1,611.3
27	GTM-Entrepose	France	2,075.7	619.3
28	John Brown Engineers & Constructors	England	2,066.0	1,743.0
29	Foster Wheeler Corp.	United States	2,048.0	1,426.0
30	Fujita Corp.	Japan	1,980.0	83.0
31	Hochtief AG	West Germany	1,947.0	686.0
32	Sato Kogyo Co., Ltd.	Japan	1,913.2	121.1
33	Mitsui Construction Co., Ltd.	Japan	1,889.1	111.1
34	Nishimatsu Construction Co., Ltd.	Japan	1,803.7	225.9
35	Maeda Construction Co., Ltd.	Japan	1,800.2	87.7
36	SADE/SADELMI Group of Cos.	Italy	1,799.0	1,795.4
37	Toda Construction Co., Ltd.	Japan	1,779.4	55.1
38	Dravo Corp.	United States	1,728.7	467.2
39	Tokyu Construction Co., Ltd	Japan	1,680.0	90.0
40	IMPRESIT SpA	Italy	1,632.4	1,345.9
41	Skanska AB	Sweden	1,623.0	248.0
42	Jones Group Inc.	United States	1,597.9	26.8
43	Kaiser Engineers Inc.	United States	1,587.5	494.1
44	Enka Construction & Industry Co., Inc.	Turkey	1,572.5	1,081.6
45	JGC Corp.	Japan	1,420.2	1,020.1

Note: Figures include prime contracts, shares of joint ventures, subcontracts, design-cons[illegible] contracts and construction management contracts where the firm is exposed to financial liability similar to a general contractor (greater than $500,000). Design-construct contracts [illegible] based on the erected value of the plant, including installed equipment. Construction management contracts are based on the erected value of the project managed.

Source: Engineering News-Record and International Construction Week. Used with [illegible]mission.

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U.S.-Japan Trade Dialogue Continues

Five days of subcabinet-level talks in Tokyo suggest that the U.S. trade agenda with Japan remains as full as ever and that the two sides remain committed to finding negotiated solutions. Bruce Smart, under secretary of Commerce for international trade, and Michael Smith, deputy U.S. Trade Representative, led the U.S. delegation in talks with the Ministry of International Trade and Industry's Vice Minister for International Affairs Makoto Kuroda January 27-31.

The speech may have been the chief executive's most comprehensive summary of his philosophy and specific policy objectives since taking office. Although some reactions to it were negative -- the Yomiuri Shimbun, Japan's largest daily, mildly objected that the speech was too vague -- it represents a thorough summation of his objectives for the Diet and his perception of Japan's role in the world. The reform theme was the unifying element of the address and in this respect it is significant that he referred to international issues at the outset. One is left with the impression that just as the Diet has restructured former government corporations to make them conform to international trends, Mr. Nakasone would like to see his countrymen reform their attitudes, self-perceptions and institutions to engineer a larger role for Japan in the world.

Michael W. Chinworth

Japan's 1986 Trade Figures: Has The Surplus Peaked?

Finding something good to say about Japan's 1986 trade figures would have tested the resourcefulness of the most experienced public relations firm. After all, just two weeks before the Reagan administration was expected to announce that the U.S. trade deficit had hit a mind-boggling $170 billion, the Ministry of Finance revealed that Japan had run up an $82.7 billion surplus -- $36.6 billion more than the politically explosive 1985 number (see Table 1). To make matters worse, exports, which had increased by a slim 3.2 percent in 1985, jumped 19.1 percent to $209.2 billion (f.o.b.), while imports slipped 2.3 percent in 1986 to $82.7 billion (c.i.f.) after declining by 5.1 percent the year before.

Arguing that the dollar figures were skewed by the yen's 25 percent appreciation during 1986 had limited public relations value since even in yen terms Japan chalked up a record-breaking surplus for the fourth straight year (see Table 2). It is equally difficult to make the case that Japan's trade surplus on a quarterly basis has peaked. But the run-up in the yen's value since September 1985 is clearly moving the export and import volume numbers in the right direction.

For starters, the volume of exports declined in each of 1986's four quarters, capped by a 4.2 percent drop in the October-December period (see Table 3). For the year as a whole, overseas shipments corrected for price changes were off by 1.4 percent -- the first drop since the worldwide recession of 1982 curbed exports. More importantly perhaps, the volume of imports expanded by a strong 13.3 percent last year even though the economy was just muddling along and deliveries of crude oil, which makes up more than one-third of the quantity index, fell by 3.6 percent. Behind this expansion, Nakasone administration officials were happy to point out, were greater purchases of foreign manufactured products -- up by nearly one-fourth in real terms after a scant 1.1 percent increase in 1985.

Finding the same thin silver lining to the numbers on Japan's 1986 trade with the United States was hard. At $51.5 billion last year, the bilateral trade surplus was $12 billion more than in 1985 as exports climbed 23.3 percent to $80.5 billion while imports expanded by a more moderate 12.4 percent to $29 billion (see Table 4). Moreover, whether measured in yen (see Table 5) or dollars, the quarterly surplus was still expanding in 1986's last three months even though the comparable overall figure had seemingly reached a plateau. Therefore, while Japan's surplus with all countries is likely to peak during the current quarter, it will probably be the second half of 1987 before a turnaround is apparent in the bilateral black-ink entry.

Susan MacKnight

Table 1: Japan's Trade in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1982	$138,831	-8.7%	$131,931	-7.9%	$6,900
1983	146,928	5.8	126,393	-4.2	20,534
1984	170,114	15.8	136,503	8.0	33,611
1985	175,638	3.2	129,539	-5.1	46,099
1986*	209,164	19.1	126,498	-2.3	82,666
1985					
I	38,503	-1.3	32,513	-5.7	5,991
II	43,748	0.6	32,094	-7.0	11,654
III	43,909	2.7	31,239	-8.1	12,671
IV	49,478	10.3	33,693	0.5	15,785
1986					
I	45,520	18.2	33,060	1.7	12,460
II	53,178	21.6	31,485	-1.9	21,693
III	54,786	24.8	30,163	-3.4	24,623
IV*	55,679	12.5	31,790	-5.6	23,890

Table 2: Japan's Total Trade in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1982	Y34,433	2.9%	Y32,656	3.8%	Y1,776
1983	34,909	1.4	30,014	-8.1	4,895
1984	40,325	15.5	32,321	7.7	8,004
1985	41,956	4.0	31,085	-3.8	10,871
1986*	35,293	-15.9	21,567	-30.6	13,725
1985					
I	9,898	9.5	8,340	4.3	1,559
II	11,025	11.1	8,093	2.8	2,932
III	10,591	2.4	7,534	-8.3	3,057
IV	10,442	-5.3	7,118	-13.6	3,323
1986					
I	8,678	-12.3	6,345	-23.9	2,333
II	9,121	-17.3	5,409	-33.2	3,712
III	8,635	-18.5	4,760	-36.8	3,876
IV*	8,859	-15.2	5,054	-29.0	3,805

Table 3: Change in Volume of Japan's Exports and Imports

	Exports	Imports
1982	-2.4%	-0.6%
1983	8.7	1.3
1984	15.4	10.7
1985	4.7	0.2
1986*	-1.4	13.3
1985		
I	6.9	0.6
II	6.8	-0.3
III	4.0	-2.8
IV	1.9	3.3
1986		
I	-0.1	3.7
II	-0.8	16.8
III	-0.2	18.8
IV*	-4.2	14.3

Table 4: Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1982	$36,330	-5.9%	$24,179	-4.4%	$12,151
1983	42,829	17.9	24,648	1.9	18,181
1984	59,937	39.9	26,862	9.0	33,075
1985	65,278	8.9	25,793	-4.0	39,485
1986*	80,462	23.3	28,984	12.4	51,478
1985					
I	13,346	6.8	6,771	1.3	6,575
II	16,837	9.0	6,641	-1.6	10,196
III	16,615	5.4	6,111	-9.8	10,504
IV	18,480	13.9	6,270	-5.7	12,211
1986					
I	16,706	25.2	6,275	-7.3	10,431
II	20,923	24.3	8,272	24.5	12,651
III	21,281	28.1	7,518	23.0	13,764
IV*	21,552	16.6	6,920	10.4	14,632

Table 5: Japan's Trade with the United States in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1982	Y9,015	5.8%	Y5,991	7.9%	Y3,025
1983	10,179	12.9	5,855	-2.3	4,323
1984	14,221	39.7	6,364	8.7	7,858
1985	15,583	9.6	6,213	-2.4	9,369
1986*	13,565	-12.9	4,906	-21.0	8,659
1985					
I	3,429	18.3	1,737	11.9	1,692
II	4,244	20.4	1,674	8.8	2,569
III	4,008	5.2	1,474	-10.0	2,534
IV	3,903	-2.1	1,328	-18.7	2,575
1986					
I	3,193	-6.9	1,202	-30.8	1,991
II	3,589	-15.4	1,415	-15.5	2,174
III	3,356	-16.3	1,189	-19.3	2,167
IV*	3,427	-12.2	1,100	-17.2	2,327

*Preliminary
Source: Japan Tariff Association

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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JEI

REPORT

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FY 1987 OUTLOOK FOR THE JAPANESE ECONOMY

Summary

Japan's economic expansion, which began in March 1983, ended in the first quarter of 1986 with a 1.7 percent contraction. Its industrial sector has been shocked by the appreciation of the yen; Nippon Steel Corp. has announced layoffs, Nissan Motor Co., Ltd. has suffered its first operating loss, and Japan's oldest coal mine is slated to close. Mining and manufacturing production declined last year for the first time in 11 years. The loss of jobs in the manufacturing sector has made unemployment a major issue for the first time. Private-sector economists expect inflation-adjusted growth to fall to about 2 percent in FY 1986 (April 1, 1986-March 31, 1987), the lowest since the 1973-74 oil shock.

The government's FY 1987 outlook projects a strong rise in domestic demand that will offset falling net exports and boost gross national product by 3.5 percent in real terms. The deflationary effect of the strong yen on export-oriented industries, though, is likely to spread to other sectors and keep growth in the 2 to 3 percent range. External demand will have a negative impact for the second consecutive year. One positive note is the expected decline in Japan's large current account surplus.

Domestic Demand Versus External Demand

Japan's economy in 1986 was hard-hit by the 65 percent appreciation of the yen that began in February 1985. Exports declined in terms of volume and yen value (see Table 1), exerting a drag on the economy for the first time in eight years. The government estimates FY 1986 real growth at 3 percent, the lowest postwar level since fiscal 1974's negative rate after the first oil shock. The rise of the yen has meant the worst of both worlds; falling net external demand is slowing the economy at the same time Japan's trade surplus in dollar terms is hitting record levels, exacerbating tensions with the country's trading partners. The trade surplus is expected to rise from $61.6 billion in FY 1985 to $94 billion in the current fiscal year, as currency changes outweigh volume changes (the J-curve effect).

Table 1: Exports and Imports, 1986

(percent change from year-earlier levels)

	January-March	April-June	July-September	October-December*	Year*
Exports					
Volume	-0.1%	-0.8%	-0.2%	-4.2%	-1.4%
Yen value	-12.3	-17.3	-18.5	-15.2	-15.9
Dollar value	18.2	21.6	24.8	12.5	19.1
Imports					
Volume	3.7	16.8	18.8	14.3	13.3
Yen value	-23.9	-33.2	-36.8	-29.0	-30.6
Dollar value	1.7	-1.9	-3.4	-5.6	-2.3

*Preliminary

Source: Japan Tariff Association

The appreciation of the yen was a serious blow to the expansion that began in March 1983. Net exports accounted directly for 24 percent of growth in the 1984-85 period, in addition to fueling a double-digit increase in business investment. In contrast, domestic spending in real terms grew sluggishly at about 2.5 percent. The challenge in fiscal 1987 (April 1, 1987-March 31, 1988) will be to achieve sufficient domestic demand to offset declining net exports.

Although Japan's economy is often described as export-dependent, domestic demand actually played a more important role until recently. During the 1970s, a contraction in external demand slowed growth in four years and the current account surplus averaged only $2.5 billion (see Table 2). Japan's large trade surpluses in the 1980s reflect several factors, including less expensive oil and raw material imports. At the same time, the rise in the dollar, primarily a result of the large U.S. budget deficit, has encouraged a surge in exports to the United States.

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Table 2: Components of Japan's Real Economic Growth

	Total Rate	Domestic Component	External Component	Current Account Surplus*
FY 1970	8.3%	8.9%	-0.7%	$2.3
FY 1971	5.3	4.0	1.3	6.3
FY 1972	9.7	10.6	-0.8	6.2
FY 1973	5.3	7.5	-2.2	-3.9
FY 1974	-0.2	-2.8	2.6	-2.3
FY 1975	3.6	2.0	1.6	0.1
FY 1976	5.1	3.6	1.5	4.7
FY 1977	5.3	4.2	1.0	14.0
FY 1978	5.1	6.9	-1.8	11.9
FY 1979	5.3	4.8	0.5	-13.9
FY 1980	4.0	1.0	3.0	-7.0
FY 1981	3.3	2.1	1.2	5.9
FY 1982	3.2	2.7	0.5	9.1
FY 1983	3.7	2.1	1.5	24.2
FY 1984	5.1	3.8	1.2	37.0
FY 1985	4.3	3.6	0.7	55.0
FY 1986**	3.0	4.4	-1.4	88.0
FY 1987***	3.5	4.0	-0.5	77.0

*In billions of dollars.
**Calculated from government's real growth estimate of 3 percent.
***Government outlook.

Source: Economic Planning Agency

Government's Economic Outlook

Despite the adverse effects of the strong yen, the Japanese government's economic outlook, adopted by the cabinet December 24, forecasts 3.5 percent real growth in FY 1987 (see Table 3). Finance Minister Kiichi Miyazawa has predicted that the economy will bottom out in the latter half of calendar 1987 if effective government policies are pursued. Economic officials believe moderately high domestic growth is essential to reduce the country's trade surplus and prevent a rise in unemployment. Tokyo is counting on domestic demand to boost the economy by 4 percent to offset the external sector's 0.5 percent negative impact. The demand will have to come mainly from the private sector, as government spending is scheduled to rise only 1.1 percent in real terms and is expected to account for only 0.2 percentage point of growth.

A further rise in the yen, however, could scuttle the government's optimistic scenario. The rise beyond the Y204=$1.00 rate assumed in the government's initial FY 1986 outlook, for example, made 4 percent real growth unattainable. While the outlook for the coming fiscal year assumes an exchange rate of Y163=$1.00, the surge above the 150 yen level on January 19 created considerable uncertainty. The Bank of Japan, which views exchange rate stability as the key to economic recovery, has promised to do everything possible to stabilize the yen. There is likely to be continued downward pressure on the dollar, however, until the U.S. trade deficit begins to fall and the American economy shows more strength.

Table 3: Japanese Government's FY 1987 Forecast

	Actual			Estimated	Projected
	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987
Real Gross National Product	3.7%	5.1%	4.3%	3.0%	3.5%
Consumer Spending	3.0	2.6	2.6	3.7	3.4
Residential Construction	-8.9	0.5	2.9	12.7	7.1
Private Capital Spending	4.9	11.4	12.9	5.2	6.6
Government Expenditures	1.2	0.8	-1.6	5.5	1.1
Exports	8.7	15.5	1.8	-3.0	-0.7
Imports	-0.5	9.8	-2.4	4.9	2.4
Current Account Surplus*	$24.2	$37.0	$55.0	$88.0	$77.0
Trade Surplus*	$34.5	$45.6	$61.6	$94.0	$81.0
Wholesale Prices	-2.3	0.2	-2.9	-9.7	1.0
Consumer Prices	1.9	2.2	1.9	0.5	1.6

*In billions of dollars.

Private-sector growth forecasts average only 2.1 percent for FY 1986 (see Table 4), which will be substantially below the 3.8 percent and 2.6 percent rates achieved in the first two quarters (see Table 5). Even if the economy accelerates modestly in fiscal 1987, the consensus is that growth will only reach 2.4 percent. This slow-growth forecast reflects doubts that the vibrant nonmanufacturing sector is strong enough to lift the economy out of the "strong-yen recession." It is more likely, many analysts argue, that the slump in the manufacturing sector will spill over to the nonmanufacturing sector.

External Demand

Projections of Japan's net foreign demand depend heavily on the U.S. economy, which absorbed nearly 40 percent of Japanese exports in 1986. The U.S. economic recovery, now over 50 months old, will become the longest peacetime expansion in the postwar era if it continues through October 1987. While business cycles do not die of old age, the extended expansion has now satisfied the backlog of consumption and investment demand that accumulated during the stagflation of the 1970s and the 1981-82 recession. But the real income gains that have fueled consumer spending and sustained the expansion through 1986 could be threatened by higher inflation. Consumer prices rose only 1.9 percent last year because of the collapse of oil prices. By the end of 1986, however, inflation was back in the 3 percent range, and the administration forecasts a 3.8 percent rise in 1987.

The large decline in the dollar's value over the past two years, though, should be a positive factor for the U.S. economy. A modest improvement in exports and the diversion of demand to domestic sources will probably lower the U.S. trade deficit by $20 to $40 billion, adding 0.5 to 1 percentage point to growth. The improvement in the trade position should sustain the current expansion through 1987 at the moderate 2.5 to 3 percent pace that has prevailed since mid-1984, despite slowing domestic demand. It follows that the increase in total U.S. imports will be below 1986's 9.8 percent gain.

Table 4: Summary of Private Forecasts

(percent change in real terms)

	GNP FY 1986	GNP FY 1987	Current Account Surplus*	Y/$ Exchange Rate	Oil Price ($/barrel)
Banks					
Hokkaido Takushoku Bank	1.8%	2.1%	$74.3	Y170.5	$15.1
Fuji Bank	2.0	1.7	70.0	161.0	17.5
Taiyo Kobe Bank	2.0	2.5	84.6	162.5	14.5
Sumitomo Trust	2.1	3.0	76.8	160.0	15.1
Mitsubishi Trust	2.1	2.4	75.7	157.0	15.6
Bank of Yokohama	2.1	1.9	65.6	160.0	15.0
Dai-Ichi Kangyo Bank	2.2	2.6	88.5	150.0	15.0
Nippon Credit Bank	2.2	2.7	72.5	157.5	16.5
Yasuda Trust	2.2	1.9	86.1	160.0	15.5
Bank of Tokyo	2.3	2.7	72.2	153.5	15.6
Mitsui Trust	2.3	1.9	70.4	154.3	15.0
Tokai Bank	2.4	1.6	80.0	150.0	15.0
Insurance Companies					
Asahi Mutual Life	1.9	2.6	96.5	159.0	15.5
Tokio Marine	2.1	2.5	71.2	163.0	15.6
Meiji Mutual Life	2.3	2.4	75.6	157.5	15.0
Nippon Life	2.4	2.3	88.0	160.0	17.0
Research Organizations					
Mitsubishi Research Institute	1.9	1.8	86.8	163.0	16.0
Okasan Economic Research Institute	2.1	2.3	87.1	152.5	15.0
Kangyo Kakumaru Research Institute	2.1	3.0	82.6	165.0	16.0
Nomura Research Institute	2.2	2.3	73.5	152.0	13.0
Cosmo Research Center	2.3	2.7	73.9	160.0	14.8
Japan Economic Research Center	2.3	3.1	85.7	151.3	15.9
Nikko Research Center	2.4	2.7	73.9	161.5	16.0
Sanwa Research Institute	2.5	2.5	73.1	158.0	15.0
Research Institue of the National Economy	2.5	3.5	81.3	155.0	14.8
Average Forecast	2.1	2.4	78.6	158.1	15.4

*In billions of dollars.

Table 5: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1985	October-December 1985	January-March 1986	April-June 1986	July-September 1986
Gross national product	Y293,332.7 (4.3%)	Y295,760.3 (4.7%)	Y294,483.4 (-1.7%)	Y297,230.1 (3.8%)	Y299,128.5 (2.6%)
Personal consumption spending	162,999.0 (2.6%)	163,477.4 (2.1%)	164,123.7 (1.6%)	166,134.2 (5.0%)	168,252.2 (5.2%)
Private residential construction	14,107.9 (2.9%)	14,124.4 (6.8%)	14,340.6 (6.3%)	14,808.5 (13.7%)	15,857.2 (31.5%)
Private fixed nonresidential investment	53,760.3 (12.9%)	54,811.3 (10.8%)	54,983.4 (1.3%)	55,204.3 (1.6%)	55,469.9 (1.9%)
Change in business inventories	2,016.2 (8.7%)	2,172.1 (77.0%)	1,726.5 (-60.0%)	639.5 (-98.1%)	809.4 (156.6%)
Government current expenditures	27,240.9 (1.9%)	27,370.1 (3.9%)	27,606.7 (3.5%)	27,719.2 (1.6%)	28,015.3 (4.3%)
Government fixed investment	20,772.5 (-6.4%)	20,960.5 (7.1%)	21,022.4 (1.2%)	21,785.4 (15.3%)	22,144.6 (6.8%)
Change in government inventories	297.9 (*)	608.7 (*)	39.6 (*)	3,251.8 (*)	1,795.1 (*)
Net external sector	12,138.1 (19.9%)	12,235.9 (-4.7%)	10,640.8 (-42.8%)	7,687.2 (-72.8%)	6,784.8 (-39.3%)
Exports of goods and services and factor income received	54,496.6 (1.8%)	53,973.3 (-7.1%)	52,208.9 (-12.4%)	53,044.1 (6.6%)	52,497.7 (-4.1%)
Imports of goods and services and factor income paid	42,358.6 (-2.4%)	41,737.5 (-7.8%)	41,568.3 (-1.6%)	45,356.9 (41.8%)	45,712.9 (3.2%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

With only a modest rise in U.S. demand for imports and growing trade friction with the European Community, the slump in Japanese exports is likely to continue. Government officials expect a 0.7 percent decline in constant-price yen terms in FY 1987, while the Bank of Tokyo forecasts a 4.8 percent drop in volume. Meanwhile, the strong yen should spur demand for manufactured imports, which accounted for close to 35 percent of 1986 deliveries from abroad. The Bank of Tokyo is projecting a 4 percent rise in import volume on top of FY 1986's expected 18.6 percent rise.

Although it will have a deflationary effect on the economy, the changes in trade volume should finally begin to decrease Japan's current account balance in FY 1987 after seven consecutive annual increases. The rise in the dollar value of Japan's exports finally slowed in the last three months of 1986, indicating that the J-curve effect has already peaked. Tokyo expects a $77 billion current account surplus in FY 1987, which would be equivalent to about 3.6 percent of nominal GNP, down from an estimated 4.3 percent in fiscal 1986.

Domestic Private Demand

Domestic demand will be influenced by the first major overhaul of the tax system in 37 years. The proposed tax reform plan, which is expected to be approved by the Diet this spring, was influenced by last year's changes in U.S. tax law. Japan's 15 individual tax brackets will be reduced to 13 this year and 6 in 1988 and marginal rates will be lowered (see JEI Report No. 1B, January 9, 1987). Corporate taxes, which currently are among the highest in the industrialized world, will also be reduced. The lost revenue, estimated at Y4.5 trillion ($30 billion at Y150=$1.00) over the FY 1987-89 period, will be offset in part by a 5 percent sales tax scheduled to go into effect in January 1988.

Although the tax reform is revenue neutral on paper in both FY 1987 and FY 1988, Tokyo hopes that the supply-side incentives will produce greater economic dynamism and eventually help reduce the budget deficit. The current system, which depends primarily on income taxes, was effective when income was growing rapidly, but a sales tax provides a larger and more reliable source of revenue. Moreover, it can be raised, as it has been in Europe, to provide more revenue. However, the proposed tax is politically unpopular and faces determined opposition in the Diet, where even some members of the LDP are said to be against it. Some tax analysts fear that the 5 percent levy will discourage spending at a time when Japan needs to stimulate domestic demand. Its effect, though, may be offset by the abolition of the tax exemption on interest income earned on postal savings and bank accounts of up to Y3 million ($20,000). Beginning October 1, 1987, this income will be subject to a 20 percent withholding tax -- a measure designed to discourage saving.

Since the tax reform is intended to be revenue neutral, its overall macroeconomic effect should be small in FY 1987. According to Nihon Keizai Shimbun's model of the Japanese economy, it will raise consumer prices by 0.4 percent, slowing real consumer spending by 0.1 percent. Tax reform, though, is likely to affect the timing of purchases of major consumer items and capital investment goods. With the sales tax scheduled for introduction in January 1988, there should be a surge in sales in the second half of 1987, weakening demand in the first part of 1988.

Personal Consumption Spending - Personal consumption, which accounts for more than half of Japan's GNP, grew at a robust 5 percent inflation-adjusted pace during the first half of fiscal 1986. The government's economic outlook projects a gain of 3.7 percent in the current fiscal year and 3.4 percent in FY 1987.

Increases in consumer outlays, of course, depend on real income gains. Some labor leaders have called for wage hikes equal to the average 4.5 percent won last year to give domestic demand a major boost. But the Japan Federation of Employers' Associations (Nikkeiren), anxious to hold the line on wage increases, says job security is a more important priority and warns workers not to expect raises this year. Higher labor costs, they argue, would weaken firms already hurt by the strong yen and encourage them to move production overseas.

Most analysts expect wage gains in the 2.5 to 3.5 percent range -- the smallest in 30 years. This is consistent with the government's economic outlook, which projects a 3 percent rise in per-capita employee income in FY 1987, down from an anticipated 3.2 percent this year. Income gains will be further diminished if consumer prices begin rising as forecast. The rise in the yen and the fall in oil prices resulted in a 7 percent fall in utility rates last June that will help limit the increase in consumer prices to about 0.5 percent in FY 1986. The government, though, expects prices to increase 1.6 percent in fiscal 1987, reducing real income gains to only 1.4 percent -- about half of this year's.

Further weakening consumer spending is the country's rising unemployment, an issue that has pushed its way to the top of the political agenda despite the fact that the rate is low compared to other nations. It is estimated, though, that the 2.8 percent unemployment rate reported for 1986 would be roughly twice as high if it were calculated according to the U.S. definition. Prime Minister Yasuhiro Nakasone acknowledged recently that preserving jobs is a major task for the government.

Although the government expects unemployment to remain at a record high level of 2.9 percent in FY 1987, many economists doubt that it can be kept below 3 percent. According to a Ministry of International Trade and Industry official, the economy would have to grow at a 3.9 percent real rate to prevent unemployment from increasing. The problem is of particular concern in the manufacturing sector. A December report by the Economic Planning Agency estimated that the manufacturing sector employed 300,000 redundant workers. Their dismissal alone would raise unemployment by 0.5 percentage point.

Private-sector forecasters, such as Sanwa Research Institute, predict that Japan's unemployment rate will rise as high as 3.5 percent by the end of fiscal 1987 as more and more firms decide to move production facilities out of Japan in order to remain competitive. Wages in Japan are six times higher than in South Korea and Taiwan. Mitsubishi Research Institute estimates that direct foreign investment will cost Japan 150,000 manufacturing jobs in 1987.

Private Plant and Equipment Investment - Corporate earnings and sales are down sharply in FY 1986. Yamaichi Research Institute is predicting that profits will fall 19.3 percent while sales drop 11.4 percent. There is a sharp contrast, though, between nonmanufacturing and manufacturing; the latter's profits are expected to fall as much as 32.3 percent, as exporters pass on only about half of the yen's rise in export prices in an effort to maintain market share abroad.

The slump in earnings has helped slow the real increase in capital spending from its double-digit pace to an estimated 5.2 percent during the current fiscal year. Several factors, however, support the government's forecast that business investment will rise to 6.6 percent in fiscal 1987. The current record-low interest rates reduce borrowing costs and encourage investment. Last month, for example, the long-term prime rate was lowered to 5.8 percent, an all-time low. Moreover, corporate profits are expected to increase in fiscal 1987 by as much as 13.2 percent, according to Nomura Research Institute. Given their reluctance to raise export prices, manufacturers must reduce costs to maintain their earnings. Efforts to maintain competitiveness in the face of the strong yen should also encourage investment during the next several years.

Private Residential Construction - Increased investment in housing has received support, both in Japan and abroad, as a way of improving the standard of living while expanding domestic demand and reducing the trade surplus. Although housing construction accounts for less than 5 percent of GNP, it has a significant impact on the rate of growth. Housing investment is estimated to increase total production by 2.2 times the original investment compared to only 1.7 times for household consumption.

Encouraged by low interest rates and government incentives, housing starts in 1986 were expected to top 1.35 million, the highest since 1979. Despite rising land prices, the housing market should remain strong. The government economic outlook projects a 7.1 percent real rise in residential construction in FY 1987 on top of a 12.7 percent increase in the current fiscal year.

Government Economic Policies

Monetary policy was at the forefront of Tokyo's efforts to stimulate the economy in 1986. Money supply growth was steady in the 8 to 9 percent range (M2+CDs). The Bank of Japan's official discount rate, the fee charged on loans to financial institutions, was cut four times to a record low of 3 percent, resulting in a general decline in interest rates. The interest rate on ordinary deposits, for example, was cut to 0.26 percent last November. As a result, policy changes to stimulate the economy in the coming year will have to come primarily from the fiscal side.

The draft budget for FY 1987, which is likely to be adopted intact by the Diet, attempts to accommodate two contradictory demands. As part of the government's goal to end reliance on deficit-financing bonds, discretionary expenditures are to be cut for the fifth consecutive year (see JEI Report No. 1B, January 9, 1987). The general account budget (discretionary spending plus public debt service and transfers to local government) is slated to rise only 0.02 percent to Y54,101 billion ($360.7 billion), the smallest increase in 32 years. To expand domestic demand, spending under the Fiscal Investment and Loan Program is projected to increase 22.2 percent, resulting in an overall 5 percent rise in public works spending. (The so-called "second budget" is financed primarily by postal savings and public pension funds.)

Tokyo's spending restraint will allow it to reduce the ratio of government bond issues to total revenues to a projected 19.4 percent in FY 1987, the first year since FY 1975 that the figure is expected to come in under 20 percent. It is unlikely, however, that the government will be able to stop issuing deficit-covering bonds by fiscal 1990. The scheduled Y265 billion ($1.8 billion) cut to Y4,981 billion ($33.2 billion) in FY 1987 is far less than the annual reduction necessary to reach the target.

Tokyo forecasts an inflation-adjusted 1.1 percent rise in government spending that will add 0.2 percentage point to economic growth. There has been some criticism, both at home and abroad, of the government's continued fiscal restraint in the face of the slowing economy. A Keidanren poll of business leaders taken in November reported that 64.8 percent favored fiscal policy action to revitalize the economy, while only 13.8 percent favored monetary policy adjustments. Already there are calls within the LDP for an early supplementary budget to boost the economy.

Tokyo's concern about budget deficits reflects the rising costs of servicing its public debt, which is equivalent to about 43 percent of GNP and will absorb 20.9 percent of expenditures in FY 1987 (compared to an estimated 13.5 percent in the United States). Tokyo is also concerned about the impact of its rapidly aging society. According to one study, if Japan continues its current fiscal policy with no changes in public pension policies, its public debt will exceed GNP in the year 2010. Mr. Nakasone told the Diet in December that the government's tight fiscal policy will continue. Efforts to stimulate the economy will attempt to utilize private-sector resources to implement public works projects.

Conclusion

Japan's real economic growth rate in FY 1987 should be about 2.5 percent, barring a further substantial rise in the yen. Growth will depend almost entirely on domestic private demand as the expansionary effect of fiscal policy will be minimal and declining net exports exert a substantial deflationary impact. Small wage increases, rising consumer prices and a deteriorating employment situation are likely to limit consumer spending and keep growth below the 3.5 percent government outlook.

The 1984-85 economic expansion was aided by a 23.7 percent rise in exports, about three-quarters of which was absorbed by the United States. With this country now the world's largest debtor nation, Japan can no longer rely on shipments to the United States to boost its economy. It faces structural adjustments that rival those following the oil shock. A recent survey of 400 major corporations reported that 64 percent believe it will take at least two years to adjust to the strong yen. With fiscal policy's role limited by the government's commitment to financial reconstruction, deregulation is essential to enable the private sector to make the best use of its resources.

For further information, contact Randall Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Congress Faces Uphill Battle In Developing Trade Compromise

Despite the emerging consensus in Congress and the White House that trade legislation is all but inevitable this year, areas of agreement are few and far between. The suggestions included in HR 3, S 490 and the preliminary administration proposal vary extensively in scope as well as procedure (see following table). Differences between the administration and the House are especially noticeable, and finding potential areas for compromise may be more difficult than the post-election "spirit of bipartisan cooperation" rhetoric implied.

While the White House has not unveiled a detailed version of its trade bill, it has given some indication of the measures it categorically opposes.

Relief from Imports in Strategically Vital Industries (Section 232 of the 1962 Trade Expansion Act) - The Senate proposal would require the president to respond within 90 days in Section 232 cases and to provide Congress with a written explanation of his decision. No provision concerning Section 232 is included in the House proposal.

U.S. Trade Policy - S 490 would create an executive-level National Trade Council; set up a National Trade Data Bank; and require all department heads to issue "trade impact statements" with regard to any major action. HR 3 also has extensive provisions to increase the dissemination of trade information and to improve U.S. competitiveness.

Agricultural Trade - The Senate bill would allow the Commodity Credit Corp. to give surplus commodities to cooperating organizations and to create a number of agricultural export promotion programs. HR 3 also includes several provisions to enhance agricultural trade.

Eileen Marie Doherty

CEA Report Stresses Link Between U.S. Trade And Budget Deficits

"The persistence of the Federal [budget] deficit late into the current expansion is one of the most important factors contributing to the growth of the trade deficit," according to the Council of Economic Advisers' 1987 Economic Report of the President. This analysis is a marked departure from the position taken earlier in the Reagan administration when the link between the two deficits was largely dismissed. Moreover, the report disputes the widespread notion that the competitiveness of U.S. manufacturing is a major problem, concluding that the country's strong productivity gains over the past five years were more than offset by the appreciation of the dollar from 1980 to 1985.

The study notes that the increase in imports of manufactured goods has spurred protectionism in this country, especially regarding Japan. But the rise in the U.S. trade deficit to $170 billion last year, it argues, reflects a deterioration with virtually all major U.S. trading partners rather than in a specific bilateral relationship. Although the deficit with Japan increased nearly $30 billion between 1982 and 1985, Japan's share of U.S. imports and exports changed only marginally (see Table 1).

Table 1: U.S. Trade in Manufactures, 1982 and 1985

		Share of			
	Change in bilateral balance*	U.S. imports		U.S. exports	
Country/Area		1982	1985	1982	1985
Canada	-$4.6	20.1%	18.8%	19.8%	26.2%
Japan	-29.8	25.1	26.6	6.6	7.6
Western Europe	-21.1	26.0	26.1	26.7	26.7
Latin America	-10.4	6.1	6.2	12.2	12.9
East Asian NICs**	-16.4	14.6	15.0	7.0	7.2

*In billions of dollar.
**Includes Hong Kong, Singapore, South Korea, and Taiwan.

Source: Council of Economic Advisers, Economic Report of the President, 1987.

The rise in the U.S. trade deficit to more than 4 percent of real gross national product in 1986, the study says, is a "macroeconomic phenomenon" that is a result of strong growth in the U.S. economy relative to other countries, the debt crisis and the appreciation of the dollar from 1980 to 1985. Weak economic recoveries abroad slowed U.S. exports while U.S. imports surged, helping to sustain the relatively weak economic recovery in other industrial nations but contributing to the plunge in the U.S. trade balance. The 3.1 percent average annual growth of real domestic demand in Japan from 1982 to 1985, for example, was well below this country's 5.6 percent rate (see Table 2). But the change in trade balances equalized the real GNP growth rates in the two countries.

Table 2: Economic Growth in Major Industrial Countries

(average annual percent change)

	1970 to 1980		1980 to 1985		1982 to 1985	
Country	Real domestic demand	Real GNP	Real domestic demand	Real GNP	Real domestic demand	Real GNP
United States	2.5%	2.8%	3.4%	2.4%	5.6%	4.2%
Canada*	4.9	4.6	2.1	2.5	4.2	4.2
Japan	4.2	4.7	2.8	3.9	3.1	4.3
France*	3.7	3.6	1.2	1.2	0.8	1.2
Germany	2.7	2.7	0.2	1.3	1.9	2.4
Italy*	2.9	3.1	0.4	0.9	1.5	1.7
United Kingdom*	1.7	1.9	1.9	1.9	3.1	3.1

*Based on real gross domestic product.

Source: Council of Economic Advisers, Economic Report of the President, 1987.

The report stresses that as the U.S. current account deficit declines, stronger internal growth in other industrial countries is necessary to maintain satisfactory growth in the world economy. This can be achieved by removing the structural distortions that impede growth. In the case of Japan, the report suggests removing restrictions that prevent the efficient use of scarce land and lifting controls on consumer credit that limit the demand for consumer durables.

The CEA points out that the deterioration in the U.S. international payments position is closely related to changes in national saving and investment. The private saving-investment balance -- the difference between private saving and private investment -- fell from 3.5 percent of GNP in 1982 to a negative 0.1 percent in 1986. This reflects the normal growth of consumption and investment over the course of the economic recovery. It has been accompanied, however, by an unprecedented deterioration in the U.S. fiscal position during an expansion. The general government budget deficit, equivalent to 3.4 percent of GNP in 1986, brought in large capital inflows and resulted in a corresponding current account deficit. The study warns Congress that "a vote for more government spending is a vote against correcting our trade deficit."

The study downplays the importance of America's industrial "competitiveness" problem, which Congress and the administration have been promoting as a central theme of this year's economic policy debate. Last month, for example, President Reagan unveiled 43 proposals to improve the U.S. competitive position in the world. The CEA points out, however, that U.S. labor productivity in manufacturing has grown at an annual rate of 3.8 percent since 1981 compared to the postwar average of 2.6 percent. At the same time, real hourly compensation in manufacturing has been held to an average annual rate of 1 percent since the business cycle peak, only half the postwar average.

As a result of strong productivity growth and modest wage gains, unit labor costs in manufacturing have actually risen more slowly here than abroad (see Table 3). But the 5 percent gain in this country's international cost competitiveness (based on national currencies) was wiped out by the rise in the dollar in the first half of the decade, which boosted the ratio of U.S. unit labor costs to foreign unit labor costs by 39 percent. The gap, however, has been narrowed significantly by the appreciation of the dollar since 1985.

Table 3: U.S. and Foreign Unit Labor Costs, 1980-85

(1980=100)

		Other Industrial Countries*	
Year	United States	National currency basis	Dollar basis
1980	100.0	100.0	100.0
1981	107.3	108.2	96.9
1982	114.0	114.4	91.6
1983	111.1	115.4	88.5
1984	110.5	115.1	81.9
1985	111.2	116.3	80.3

*Trade-weighted average of Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Norway, Sweden and United Kingdom.

Source: Council of Economic Advisers, Economic Report of the President, 1987.

The CEA calls on all countries to avoid new protectionist measures and to reduce existing barriers. Protectionism is likely to increase in other countries as they face serious adjustment problems stemming from the decline in the U.S. trade deficit. It would be unfortunate, the report states, if the "United States were to suggest -- just as its trade position was beginning to improve -- that protectionist measures were an acceptable response to these adjustment pressures."

Randall S. Jones

Japan's 1986 Balance Of Payments Sets New Records

Japan's current account and trade surpluses jumped to record highs in 1986, propelled by an 18 percent rise in exports to $205.6 billion (see Table 1). At the same time, the all-time-high net long-term capital outflow indicated that Japan was actively recycling these funds abroad.

Table 1: Japan's Global Balance of Payments

(in millions of dollars, IMF value basis)

	1982	1983	1984	1985	1986*
Current Account	$6,850	$20,799	$35,003	$49,169	$85,966
Trade Balance	18,079	31,454	44,257	55,986	92,659
Exports (f.o.b.)	137,663	145,468	168,290	174,015	205,558
Imports (f.o.b.)	119,584	114,014	124,033	118,029	112,899
Services	-9,848	-9,106	-7,747	-5,165	-4,633
Transfers	-1,381	-1,549	-1,507	-1,652	-2,060
Long-Term Capital	-14,969	-17,700	-49,651	-64,542	-131,814
Basic Balance	-8,119	3,099	-14,648	-15,373	-45,848
Short-Term Capital	-1,579	23	-4,295	-936	-1,302
Errors and Omissions	4,727	2,055	3,743	3,991	2,383
Overall Balance	-4,971	5,177	-15,200	-12,318	-44,767

*Preliminary.

Source: The Bank of Japan

As expected, the appreciation of the yen began to influence trade flows in 1986. Based on Japan's customs clearance data, export volume fell 1.4 percent while import volume rose 13.3 percent, but these changes were more than offset by the realignment of exchange rates that boosted the trade surplus from $56 billion in 1985 to $92.7 billion last year.

Led by the increased trade surplus, the current account surplus rose to $86 billion. A fifth annual decline in the services deficit also contributed to the increase. This improvement resulted from a 37.4 percent rise in net investment income to $9.4 billion, reflecting Japan's status as the world's largest creditor nation.

There are signs that the J-curve effect may have peaked, at least for exports, in the July-September period last year, making a decline in the 1987 surplus likely. The Organization for Economic Cooperation and Development predicts that Japan's trade and current account surpluses will fall by about $4 billion each.

Japan's net long-term capital outflow more than doubled to $131.8 billion in 1986 (see Table 2). Net direct foreign investment increased substantially to a record $14.3 billion, as more firms moved production facilities abroad in order to remain competitive. Most of the increased outflow, though, was a result of big purchases of foreign securities, which rose to $101.6 billion, with bonds accounting for $95.1 billion. While a breakdown by region is not yet available, it is likely that the U.S. share of net portfolio investment matched 1985's 70 percent.

Table 2: Net Long-Term Capital Flows

(in millions of dollars)

	1985			1986*		
	Outflows	Inflows	Net	Outflows	Inflows	Net
Direct Investment	-$6,452	$642	-$5,810	-$14,478	$224	-$14,254
Trade Credits	-2,817	29	-2,788	-2,040	-41	-2,081
Loans	-10,427	-75	-10,502	-9,153	-34	-9,187
Securities	-59,773	16,741	-43,032	-102,108	545	-101,563
Stocks	-995	-673	-1,668	-7,048	-15,758	-22,806
Bonds	-53,479	4,524	-48,955	-93,024	-2,109	-95,133
Yen-denominated Bonds Issued in Japan	-5,299	n.a.	-5,299	-2,036	n.a.	-2,036
External Bonds**	n.a.	12,890	12,890	n.a.	18,412	18,412
Other	-2,346	-64	-2,410	-4,583	-146	-4,729
Total	-81,815	17,273	-64,542	-132,362	548	-131,814

Note: A negative sign indicates a capital outflow.

*Preliminary.
**Bonds issued outside of Japan by Japanese institutions.

Source: The Bank of Japan

Randall S. Jones

Tax Reform Grabs Center Stage In Diet Debates

The current Diet session is off to a rocky start as opposition and majority party members alike direct a barrage at the Nakasone cabinet's proposal to offset proposed personal income tax cuts with a 5 percent sales tax. The intensity of the debate suggests that tax reform is within the government's grasp but will not be achieved easily.

The government's difficulties began almost as soon as the prime minister delivered his policy address January 26 (see JEI Report No. 5B, February 6, 1987). Opposition parties led a walkout from the Diet, halting proceedings for five working days until they secured token compromises from the government on the tax reform debate. The walkout -- a stale opposition tactic left over from countless sessions in the past -- betrayed the claims of minority party leaders that they would vigorously pursue new policy options. It is particularly disappointing in the case of Takako Doi, head of the Japan Socialist Party, whose designation as the first woman to lead a major political party in Japan is said

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JEI

REPORT

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"Adversarial Trade" Proposal: More Talk Than Action

The "adversarial trade" proposal included in S 490 has received a large amount of attention since the introduction of the Senate omnibus trade bill on February 5. Labeled by some as the Senate's alternative to HR 3's mandatory trade surplus reduction provision (the "Gephardt amendment"), the Senate proposal is at first glance a tough response to the unfair trade practices of other countries. A careful examination, however, reveals that the provision is not a significant departure from current law.

Under S 490, the U.S. Trade Representative must identify those countries that the National Trade Estimate reports maintain trade barriers and also have adopted a "consistent pattern of barriers and market-distorting practices." (The National Trade Estimate is USTR's annual inventory of barriers to U.S. exports. See JEI Report No. 45B, December 12, 1986.) The president must then initiate negotiations to eliminate all distortions and report to Congress by the end of 1988 on his progress, listing any increases in U.S. exports to the

Financial Markets In Japan: A Look Backward And Forward

Japanese financial institutions and markets continue to boil over with activity. Slower economic growth, a stronger yen and progressive deregulation have resulted in reduced domestic demand for investment, large sums of idle cash and greater access to foreign financial markets. Just as Japanese firms have been actively expanding abroad, foreign competitors have been busy building a stronger presence in Japan. Not surprisingly, this flurry of activity has led to record trading volumes on several markets.

According to the daily Nihon Keizai Shimbun, the outstanding balance of short-term financial instruments jumped an estimated Y50 trillion ($322.6 billion at Y155=$1.00) in 1986 to Y130 trillion ($838.7 billion) at yearend. This broad category includes the call money and bill-discount interbank markets, which grew by some Y5 trillion ($32.3 billion) to Y24 trillion ($154.8 billion); foreign currency deposits, which doubled to Y20 trillion ($129 billion); large time deposits, which jumped four times to the same level; short-term government bonds, which rose to Y2 trillion ($12.9 billion); certificates of deposit, money market certificates, bonds with repurchase agreements (gensaki) and the Tokyo dollar call market.

The Tokyo International Banking Facility, or offshore market, has gotten off to a strong start. At the end of December, its first month of operation, deposits totaled Y11 trillion ($71 billion); a month later they came to approximately Y17 trillion ($109.7 billion). This led the Ministry of Finance to predict that the Tokyo IBF will pull abreast of the New York offshore facility (which had a closing 1986 volume of $260 billion or so) in two to three years. The new market is apparently attracting funds from around the globe. Southeast Asian investors have jumped at the new opportunities presented by the facility, as have Middle Eastern, Chinese and even Soviet banks. But more importantly, Japanese banks are using the market to reduce their vulnerability to fluctuations on the Tokyo dollar call market. Therefore, even though the Finance Ministry sought to insulate the domestic market from the international facility, dollar rates often move in tandem on the two.

Tokyo bond markets continue to show very strong growth. After making a huge jump in 1985 when volume rose from about Y800 trillion ($5.2 trillion) to Y2,130 trillion ($13.7 trillion), the cash market grew to Y2,650 trillion ($17.1 trillion), a gain of "only" 24.4 percent. Even greater strides were realized in the bond futures market, which opened in October 1985 and closed out that year with a volume of approximately Y200 trillion ($1.3 trillion). Institutional investors and non-financial corporations were extremely active hedging against fluctuations in the cash market. This pushed volume up to an estimated Y1,870 trillion ($12.1 trillion) -- on a par with activity at the Chicago Board of Trade, the world's largest bond futures market. An increase in the number of dealers authorized to handle central and local government bonds and government-guaranteed bonds from 87 to 136 also fueled the market's growth.

The Tokyo Stock Exchange enjoyed a bull market, with the Nikkei Index up nearly 50 percent by the end of the year. Recently the market has been gripped by public-corporation fever. Shares of Nippon Telegraph and Telephone Corp. were listed for the first time on February 9 and immediately proceeded to break records. Pushing past the Y200,000 ($1,290) daily stop limit, the issue rose from an initial Y1.2 million ($7,742) per share to Y1.86 million ($12,000) by

February 12 -- translating into a record-setting prospective price/earnings ratio of 162 and an historic p/e ratio of 206. Government-held shares of Japan Air Lines Co., Ltd. and the privatization of Japanese National Railways are expected to keep the market boiling. Foreign companies are also rushing to list on the TSE; 52 were traded on the Tokyo floor at the end of 1986, well above the 21 listed at the end of 1985. The leadership of the TSE has announced that it is considering expanding its membership by the spring of 1988 from the present 93 to around 100. More foreign firms can be expected to join the six admitted in November 1985.

Not to be left out, the over-the-counter market also enjoyed strong growth in 1986. A record 22 new firms decided to list over the counter, taking advantage of the easier criteria. (A Y10-a-share profit is required to list on any of Japan's stock exchanges.) The 1986 OTC volume was estimated to be 2.2 times that of the previous year, with 260 million shares worth Y2 trillion ($12.9 billion) traded. Several of Japan's fast-growing service companies, including Toa Domestic Airlines Co., Ltd. and Asahi Business Consulting Co., Ltd., are considering listing over the counter, presaging continued market growth.

Just as Japan's securities companies have made a big splash on New York and European markets, American firms are starting to flex their muscle in Tokyo. Salomon Brothers Asia Ltd. announced that the Ministry of Finance approved a capital infusion of $300 million, bringing its total capital up to about Y50 billion ($322.6 million), close to the smallest of the top four Japanese dealers, Yamaichi Securities Co., Ltd. Salomon has made a concerted effort to become a major player in the market for Japanese government bonds. It actually won the largest share (Y45 billion or $290.3 million) of a February 3 offering of Y110.9 billion ($715.5 million) worth of two-year bonds, with Nomura Securities Co., Ltd. winning Y30 billion ($193.5 million). According to reports, most foreign securities firms are doing well in Japan (see Table).

After-Tax Profits of Foreign Securities Companies in Japan

(in millions of yen for the year ending in September)

	1985	1986
Salomon Brothers Asia	Y269	Y1,698
Jardine Fleming Securities	329	1,395
Merrill Lynch Japan	428	552
Bache Securities (Japan)	-76	493
Morgan Stanley International	-61	404
W.I. Carr (Overseas)	102	378
First Boston (Asia)	-64	345
S.G. Warburg Securities (Japan)	6	167
Vickers da Costa	82	165
Kidder, Peabody	33	67
Smith Barney, Harris Upham	7	38
Goldman Sachs (Japan)	4	-71

Source: Japan Bond Research Institute

In the meantime, Tokyo continues to make changes, many due to its tax reform program:

- The securities transaction tax on convertible bonds will be raised from 0.045 percent to 0.26 percent of the sale price effective April 1, 1987.

- A tax of 0.002 percent will be levied on transactions in the government bond futures market.

- Taxes of undetermined size will be levied on transactions in the offshore, dollar call and uncollateralized call markets. Interest paid on certificates of deposit will remain lightly taxed.

- MOF also wants to tighten up on capital gains taxes by lowering the floor for institutional traders. Gains will be taxed after 30 transactions of 120,000 shares or more, rather than after 50 transactions of 200,000 shares.

- MOF plans to ease the criteria that foreign firms must meet to list on Japan's OTC market. The ministry hopes that this will push the TSE to ease its listing requirements.

- The Finance Ministry will raise the asset requirements for investment advisory firms. This group of about 50 foreign and domestic companies offers fund management services to individuals and corporations. MOF has received 191 applications for management licenses to be issued in May: 77 from independent firms, 26 from companies with ties to securities houses, 43 from firms linked to banks, 20 from affiliates of insurance companies and 25 from foreign companies. The ministry is requiring that firms maintain Y100 million ($645,161) in assets by the third year of operation and have Y20 billion ($129 million) in entrusted assets in order to qualify for a license. If the foreign parent has more than Y100 billion ($645.2 million) in entrusted assets, a foreign subsidiary may waive the Y20 billion requirement.

- MOF will permit commercial banks to issue domestic convertible bonds within a few months as part of its financial liberalization plan. Due to opposition by long-term credit banks, MOF will only allow the smaller regional banks to float such bonds. The larger city banks, which are expanding abroad, are pressing for similar treatment. Since the issuance of convertible bonds is tantamount to a long-term loan, MOF has hesitated but may relent by the end of this year.

- Finally, the Osaka Stock Exchange is preparing to open Japan's first stock futures market on April 6. According to a Nihon Keizai Shimbun survey, there is widespread interest in the new market. Interestingly, 85 percent of the respondents said that they would use the market as a hedge against price fluctuations of their own stock or in their portfolios; 50 percent were interested in using the market for speculation; and 42 percent said they would act to arbitrage prices between the future and spot markets. This represents an entirely new market for Japanese firms, and many are busy preparing for the opening.

Clearly Japan's financial markets have taken a quantum leap. MOF continues to deregulate incrementally, but is not reluctant to impose new rules if a market proves to be unruly, as in the consumer finance area.

Nevertheless, these fast-growing markets offer new opportunities for domestic and foreign firms alike.

Jon Choy

Defense Group Releases Semiconductor Study

Calling integrated circuits the "industrial rice" of modern industry, a special task force of the Defense Science Board urged the establishment of a government-funded effort in cooperation with the private sector to preserve the U.S. manufacturing base in the face of growing competition from Japan. In a study released February 12, the task force said that in every area of semiconductor production except one -- linear (analog) nonsilicon products -- the United States trailed or is losing its technological edge to Japan. In response, it called for a comprehensive strategy to reverse the trends that threaten to destroy this country's semiconductor production base and, by implication, its ability to rely on technological superiority to defend the nation. Some members went so far as to urge a strict "buy America" or quota policy to insure against U.S. dependence on foreign sources for integrated circuits.

While the report concluded that the United States relies on foreign supplies for approximately 10 percent of its total semiconductor needs, the DSB members are concerned that declining market share will constrain the ability of American producers to fund the basic research and development necessary to introduce new products. The report blames differences in industrial practices and structures between the United States and Japan for these performance disparities. In the area of industrial structure, for example, the authors note that Japanese firms are integrated horizontally and vertically, and almost all of them are high-volume producers, compared with many American manufacturers that tend to focus on specialty chips alone. Capital costs are considerably lower for Japanese competitors, although access to capital has not been a concern for U.S. firms, the panel notes. Finally, profit margins are far lower for Japanese producers than American firms consider acceptable. The DSB study attributes this country's loss of leadership to the impact of such factors as lower productivity, demands for higher wages, poor quality control, insufficient numbers of technically trained workers and the traditional adversary relationship among business, labor, government and academia.

The DSB proposes government support -- to the tune of about $200 million annually -- for a Semiconductor Manufacturing Technology Institute to help offset present trends. The institute would develop, demonstrate and advance the technology for efficient, high-yield manufacturing of advanced semiconductor devices. The center is not envisioned as a government-sponsored production facility, although it would have limited capacity to provide for selected Department of Defense needs. Rather, it is anticipated that the institute -- in cooperation with business, government and academia -- will provide an influx of expertise to the sagging semiconductor industrial base; the study recommends the 64-megabit DRAM (dynamic random access memory) as an appropriate first effort. In addition, the authors call for expanded research and development funding in semiconductors, higher discretionary funds for DOD to "underpin healthy industrial research and development," and the establishment of eight centers at selected universities to improve semiconductor design and manufacturing techniques in the private sector.

STATISTICAL SUPPLEMENT

Trade and Payments Data

(in millions of dollars unless otherwise indicated)

	1984	1985	January-December 1985	January-December 1986	October 1986	November 1986	December 1986
Japan's Balance of Payments							
Trade Balance	$44,257	$55,986	$55,986	$92,659*	$8,719*	$8,504*	$10,169*
Exports (f.o.b.)	168,290	174,015	174,015	205,558*	18,865*	16,590*	19,161*
Imports (f.o.b.)	124,033	118,029	118,029	112,899*	10,146*	8,086*	8,992*
Current Account Balance	35,003	49,169	49,169	85,966*	8,283*	8,144*	9,359*
Long-Term Capital (net)	-49,651	-64,542	-64,542	-131,814*	-16,348*	-13,780*	15,404*
Overall Balance	-15,200	-12,318	-12,318	-44,767	-8,081	-9,333	-7,058
International Reserves (end of period)	26,313	26,510	26,510	42,239	41,676	41,676	42,239
Japan's Customs Clearance Trade							
Trade Balance	33,611	46,099	46,099	82,666*	7,789	7,402	8,699*
Exports (f.o.b.)	170,114	175,638	175,638	209,164*	19,149	16,912	19,619*
Cars	21,899	25,402	25,402	32,955*	2,952	2,879	2,690*
Steel	13,852	13,566	13,566	12,706*	1,043	936	1,278*
Imports (c.i.f.)	136,503	129,539	129,539	126,498*	11,360	9,510	10,920*
Crude Oil	39,379	34,599	34,599	19,502*	1,235	1,255	1,443*
Japan-U.S. Trade							
Trade Balance	33,075	39,485	39,485	51,478*	4,999	4,894	4,739*
Exports (f.o.b.)	59,937	65,278	65,278	80,462*	7,507	6,893	7,152*
Imports (c.i.f.)	26,862	25,793	25,793	28,984*	2,509	1,998	2,413*
U.S.-Japan Trade							
Trade Balance (f.a.s./c.i.f.)	-36,796	-49,749	-49,749	-58,575	-4,982	-6,741	-3,825
Exports (f.a.s.)	23,575	22,631	22,631	26,882	2,286	1,990	2,305
Imports (c.i.f.)	60,371	72,380	72,380	85,457	7,268	8,731	6,130
Trade Balance (f.a.s./Customs)	-33,560	-46,152	-46,152	-55,030	-4,710	-6,402	-3,578
Exports (f.a.s.)	23,575	22,631	22,631	26,882	2,286	1,990	2,305
Industrial Supplies	9,139	8,680	8,680	8,752	835	759	878
Capital Goods	5,627	5,939	5,939	7,709	664	498	1,731
Food and Feed	5,929	5,001	5,001	5,043	458	441	390
Consumer Goods	1,476	1,416	1,416	1,690	164	155	131
Imports (Customs)	57,135	68,783	68,783	81,911	6,996	8,392	5,883
Automotive Products	18,477	24,980	24,980	32,849	2,826	3,464	2,443
Capital Goods	19,290	21,516	21,516	25,[illegible]34	2,165	2,539	1,889
Consumer Goods	11,266	14,017	14,017	15,451	1,394	1,632	967
Industrial Supplies	7,276	7,035	7,035	6,949	502	637	470

*Preliminary

STATISTICAL SUPPLEMENT

Japanese Economic Indicators

(percentage change from year-earlier period unless otherwise indicated)

	1984	1985	January-December 1985	January-December 1986	October 1986	November 1986	December 1986
Discount Rate (end of period)	5.0%	5.0%	5.0%	3.0%	3.5%	3.0%	3.0%
Outstanding Money Supply	7.8%	8.4%	8.4%	8.7%	8.5%	8.3%	8.2%
Industrial Production	11.1%	4.6%	4.6%	-0.3%	-1.0%	-2.3%	1.0%
Manufacturing Operating Rate	7.3%	1.2%	1.2%	-4.8%	-6.8%	-7.3%	-4.1%
Number of Bankruptcies	8.8%	-9.7%	-9.7%	-7.1%	-6.9%	-6.9%	-7.2%
Residential Construction Starts	4.4%	4.1%	4.1%	10.4%	14.9%	17.8%	12.9%
Job Openings to Applications (ratio)	0.65	0.68	0.68	0.62	0.61	0.61	0.62
Nominal Wages	4.3%	3.6%	3.6%	3.6%*	2.3%	4.2%	2.6%*
Labor Productivity	9.9%	4.2%	5.2%**	2.0%**	n.a.	n.a.	n.a.
Wholesale Prices	-0.3%	-1.1%	-1.1%	-9.3%	-11.3%	-10.2%	-9.9%
Consumer Prices	2.3%	2.0%	2.0%	0.6%	-0.3%	0.0%	-0.3%
Yen-Based Export Prices	0.6%	-1.4%	-1.4%	-14.5%	-12.8%	-8.5%	-7.7%
Yen-Based Import Prices	-3.4%	-2.5%	-2.5%	-34.7%	-39.0%	-35.5%	-34.4%

*Preliminary.
**Through September of each year only.

For Japan's most recent GNP figures, see JEI Report No. 46B, December 19, 1986.

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REPORT

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Major Industrial Countries Agree Dollar Has Fallen Enough

Finance ministers and central bankers from six major industrial countries agreed February 22 that currency values are now "broadly consistent with underlying economic fundamentals" and that a further decline in the dollar would hurt the world economy. The accord, in effect, is the reverse of the September 22, 1985 agreement by the Group of Five (United States, Japan, West Germany, France and Britain) that the dollar was overvalued. Last weekend's discussions in Paris added Canada to the original group. (Italy, which had been expected to participate as a member of the Group of Seven, boycotted the final meeting to protest its exclusion from the preliminary Group of Five meeting on February 21.)

The agreement, which followed weeks of private negotiations, resembled the October 31, 1986 accord negotiated by Treasury Secretary James Baker and Japan's Finance Minister Kiichi Miyazawa (see JEI Report No. 41B, November 7, Such statements underscore the rift between the congressional and executive approaches to sectoral trade issues. White House officials have said that the president will oppose attempts to protect specific sectors -- a warning that Congress may have to try to override another veto. Last year the House fell eight votes short (see JEI Report No. 30B, August 15, 1986). Given the milder provisions of S 549/HR 1154, Congress may have better luck this year.

Eileen Marie Doherty

The 1986 U.S. Trade Account: Looking For The Silver Lining

Is the worst of the U.S. trade problem over? Reagan administration trade policymakers and business economists alike are convinced that the gap between imports and exports this year will be narrower than 1986's red-ink entry of $169.8 billion (imports valued c.i.f.). But undoing four years of runaway growth in this country's trade deficit will be slow work, they caution. Even with the big drop in the dollar's value since February 1985, it will be difficult to trim the 1987 number to 1985's $148.5 billion shortfall.

A glance at the 1986 export and import figures indicates why otherwise optimistic White House economists are reluctant to predict a major turnaround in the U.S. trade account. Exports increased by a scant 2 percent last year to $217.3 billion -- or roughly 1984's level, itself $15.9 billion shy of the record set in 1981. Moreover, shipments were barely higher in the second half of 1986 than in the first six months for reasons that have a familiar ring -- the weak economic performance turned in by other industrialized nations, the debt problems of many developing countries, and the reduced revenues of oil exporters. These factors will continue to offset some of the benefits of the lower dollar in 1987. Still, the prospects for exports look better than at any time in the past five years.

The other side of the equation is a bigger question mark. At $387.1 billion in 1986, U.S. imports were up by just 7 percent -- the second year of single-digit growth. Duplicating this record in 1987 will be much harder. For one thing, the huge drop in world oil prices that helped to contain the expansion of 1986 imports was a one-time break; prices this year are expected to average a dollar or two higher. What's more, Japanese and European manufacturers will be under more pressure in 1987 to hike prices on U.S.-bound exports to reflect the steep appreciation of their currencies. Last year most foreign suppliers opted to sacrifice short-term profits for market share, but this sales strategy has obvious limits. These two factors alone guarantee a bigger gain in imports than in 1985 and 1986. How much more depends on whether the U.S. economy continues to muddle along for the whole year or, as most economists project, picks up some steam in 1987's second half.

Analysts searching for hard evidence that the U.S. trade deficit has finally bottomed out can find several pieces in an unexpected place -- the 1986 data on trade with Japan. The already yawning gap between imports and exports admittedly widened from $49.8 billion in 1985 to $58.6 billion last year (imports again valued c.i.f.), but this number masked some encouraging trends, particularly in exports.

U.S. Exports to Japan

(in millions of dollars, f.a.s. value basis)

	January-December 1985	January-December 1986	Percent Change
Total Exports	$22,630.8	$26,881.6	18.8%
Industrial Supplies	8,679.9	8,751.5	0.8
Bituminous Coal	769.1	554.7	-27.9
Petroleum Products	762.0	567.7	-25.5
Natural Gas	249.1	187.0	-24.9
Nuclear Fuels	121.5	28.7	-76.4
Logs and Lumber	884.9	1,097.4	24.0
Paper Base Stocks	470.2	563.8	19.9
Paper and Paper Products	288.9	354.0	22.5
Organic Chemicals	704.0	731.8	3.9
Inorganic Chemicals	801.9	883.9	10.2
Plastics and Synthetic Resin Compounds	305.6	322.0	5.4
Manufactured Fertilizers and Insecticides	243.1	246.1	1.2
Steel Scrap	199.1	170.0	-14.6
Nonferrous Ores and Scrap	459.6	491.8	7.0
Nonferrous Metals	289.4	205.8	-28.9
Textiles	107.5	121.7	13.2
Raw Cotton	368.0	238.6	-35.2
Hides and Skins	298.2	331.4	11.1
Leaf Tobacco	302.4	227.1	-24.9
Capital Goods	5,938.6	6,727.5	13.3
Nonelectric Machinery	3,384.7	3,561.7	5.2
Data Processing Equipment	1,331.1	1,400.6	5.2
Measuring, Testing and Control Instruments	448.7	477.2	6.4
Laboratory Testing and Control Instruments	104.5	103.9	-0.6
Scientific, Professional and Medical Equipment	265.5	337.0	26.9
Metalworking Equipment	113.9	143.0	25.5
Service Industry Equipment	120.1	143.7	19.7
Electric Machinery	804.3	977.5	21.5
Generators and Transformers	75.9	73.7	-2.9
Broadcast and Communications Equipment	327.1	402.8	23.1
Telephonic and Other Electric Equipment	401.3	500.9	24.8
Transportation Equipment	1,749.6	2,188.3	25.1
Civilian Aircraft	905.9	1,161.3	28.2
Civilian Aircraft Engines and Parts	552.1	659.6	19.5
Automotive Parts	214.8	235.0	9.4
Food and Feed	5,000.7	5,042.8	0.8
Corn	1,305.3	878.0	-32.7
Sorghum	242.9	178.0	-26.7
Soybeans	937.7	838.8	-10.5
Wheat	469.0	424.3	-9.5

Fruits and Vegetables	452.1	584.0	29.2
Meat and Meat Products	540.8	760.9	40.7
Fish and Fish Products	685.4	864.2	26.1
Consumer Goods	1,415.5	1,689.9	19.4
Pharmaceuticals	590.5	647.4	9.6
Toys and Sporting Goods	79.7	98.0	23.0
Cigarettes	94.9	128.0	34.9

U.S. Imports from Japan

(in millions of dollars, Customs value basis)

	January-December 1985	January-December 1986	Percent Change
Total Imports	$68,782.9	$81,911.1	19.1%
Automotive Products	24,980.0	32,849.1	31.5
Cars	16,231.3	21,060.7	29.8
Assembled Trucks	4,311.6	5,713.4	32.5
Automotive Parts	4,429.5	6,065.6	36.9
Capital Goods	21,515.7	25,333.9	17.7
Nonelectric Machinery	14,448.9	17,230.9	19.3
Business Machines	6,274.1	7,901.9	25.9
Metalworking Machinery	1,238.7	1,475.3	19.1
Specialized Industrial Machinery	1,323.1	1,598.0	20.8
Scientific, Professional and Medical Equipment	670.0	835.2	24.7
Electric Machinery	6,542.6	7,532.5	15.1
Transportation Equipment	524.2	570.5	8.8
Consumer Goods	14,017.2	15,451.1	10.2
Video and Audio Recorders and Players and Stereo Equipment	5,280.1	5,881.1	11.4
Television Sets	827.7	869.0	5.0
Radio Receivers	306.9	272.9	-11.1
Tableware and Glassware	442.8	453.8	2.5
Metal Cookware and Cutlery	438.3	473.0	7.9
Photographic and Optical Goods	918.5	1,164.8	26.8
Clocks and Watches	479.9	477.2	-0.6
Toys and Sporting Goods	563.8	523.1	-7.2
Motorcycles and Parts	883.8	853.3	3.5
Clothing	487.3	464.0	-4.8
Intermediate Goods	7,035.3	6,948.7	-1.2
Steel Mill Products	3,048.3	2,231.5	-26.8
Nonferrous Metals	535.0	504.6	-5.7
Organic Chemicals	564.1	732.2	29.8
Textiles	715.2	855.4	19.6

On paper, U.S. shipments to Japan increased by a whopping 18.8 percent in 1986 to $26.9 billion despite generally lower prices for the agricultural and industrial inputs that make up just under half of total exports. As has been well publicized, most of this gain was illusary, reflecting transshipments of foreign gold through the United States to Japan. Still, sales of industrial supplies, food and feed, capital goods and consumer goods did expand by a solid 5.6 percent to a new record level. More importantly, all of this gain occurred in 1986's second half; at mid-year exports were actually running 4.1 percent behind their year-earlier tally. With the Japanese economy continuing to struggle during the July-December period, this turnaround is strong proof that the weaker dollar has at last begun to boost U.S. exports.

It is more difficult to build a case that the expansion of imports from Japan has peaked. The rollback in the growth rate from 19.9 percent in 1985 to 18.1 percent last year, when purchases hit $85.5 billion, is certainly too slight to draw any conclusions, particularly given the fact that so much of the trade is distorted by restraint arrangements. There were some scattered signs that the volume gains that had propelled imports up in the first half of 1986 were less of a driving force in the second half. But whether this change reflected the sluggish pace of U.S. growth or the J-curve effect will only become clear this year.

Susan MacKnight

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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REPORT

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U.S.-Japan Trade Talks

With congressional interest in a trade bill at an all-time high, the United States and Japan held biannual subcabinet-level talks in Tokyo March 3-5 to discuss a number of issues, primarily economic restructuring, supercomputer sales and foreign participation in Japanese public works projects. The U.S. delegation, headed by Under Secretary of State for Economic Affairs W. Allen Wallis and Deputy U.S. Trade Representative Michael Smith, met with Makoto Kuroda, vice minister of international trade and industry for international affairs, Toyoo Gyohten, vice finance minister for international affairs, and Hiroshi Kitamura, deputy foreign minister. While no breakthroughs were made, the two sides are hopeful that some high-visibility issues can be solved soon.

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The actual rise in the unemployment rate was slight -- from 2.94 percent in December to 2.96 in January -- but the rounded 3 percent figure attracted widespread attention and increased pressure on the government to adopt a more expansionary fiscal policy. Prime Minister Yasuhiro Nakasone, though, remains committed to his pledge to end the issue of deficit-covering bonds by FY 1990. He did call on the Diet to resolve the political impasse that has delayed passage of the budget for FY 1987, which begins April 1. One program that could be affected by the delay is a one-year emergency plan to create 300,000 jobs. Public hearings on the budget, which have been stalled by opposition party members protesting the proposed sales tax, are slated to resume March 13. The prime minister said that approval of the budget will enable the government to introduce a package of measures to stimulate the economy. The Economic Planning Agency is currently working on a new program within the limits of the FY 1990 target.

Randall S. Jones

Japan's Exports To The Middle East Continue To Fall

With the decline in oil prices and the Iran-Iraq war, Japan's exports to oil-exporting countries in the Middle East have contracted sharply. Shipments to Japan's five largest trading partners in the region fell for the fourth consecutive year in 1986 to $7.4 billion (see Table 1). These countries accounted for only 3.5 percent of Japanese exports last year compared to nearly 10 percent in 1982.

Table 1: Japan's Exports to Middle East Oil-Exporting Countries and the United States

(in millions of dollars, f.o.b. value basis)

Country	1982	1983	1984	1985	1986
Iran	$934	$2,820	$1,692	$1,348	$1,144
Iraq	2,755	631	806	1,306	1,211
Kuwait	1,790	1,763	1,432	1,536	1,219
Saudi Arabia	6,621	6,687	5,634	3,890	2,762
United Arab Emirates	1,493	1,357	1,126	1,164	1,032
Total	13,593	13,258	10,690	9,244	7,368
Percent of total exports	9.8%	9.0%	6.3%	5.3%	3.5%
United States	36,330	42,829	59,937	65,278	80,462
Percent of total exports	26.2%	29.1%	35.2%	37.2%	38.5%

Source: Japan Tariff Association

The reduction in purchases of Japanese goods by the five nations parallels a decline in their oil sales to Japan, which has moderated its demand for energy and developed alternative sources of supply. These efforts have resulted in a decline in oil imports from the 1979 peak of 1,764 million barrels to 1,223 million barrels in 1986. Moreover, the five countries' share of Japan's market has fallen under 50 percent as Tokyo has turned to suppliers outside the Middle East. And most significantly, export earnings of the group were sharply reduced in 1986 by the decline in the price of oil from $27.93 a barrel in December 1985 to $13.80 a barrel a year later.

Table 2: Japan's Oil Imports From Middle East Countries

(in millions of barrels)

Country	1982	1983	1984	1985	1986
Iran	84	144	94	90	81
Iraq	24	3	5	26	59
Kuwait	20	21	30	16	38
Saudi Arabia	478	368	366	217	162
United Arab Emirates	181	198	206	266	268
Sub-total	787	734	701	615	608
Percent of total	58.3%	56.2	51.9%	49.3%	49.7%
Total	1,350	1,307	1,350	1,247	1,223

Source: Petroleum Association of Japan

One result of the decline in exports to the Middle East has been an increase in Japan's dependence on the U.S. market. This country's share of Japan's exports rose from 26.2 percent in 1982 to 38.5 percent in 1986. This dependence on a single market poses a risk to Japan and may not be sustainable in the long run.

Randall S. Jones

Notes

Nuclear Fuel - The United States and Japan are reportedly close to ending negotiations on a new nuclear fuel reprocessing agreement. The present agreement requires Tokyo to obtain Washington's approval for each overseas shipment of spent uranium fuel for reprocessing (see JEI Report No. 25B, July 11, 1986). This arrangement, which has been used only once, is so cumbersome from Tokyo's viewpoint that it threatens Japan's nuclear power plans. The United States, on the other hand, is concerned with security, and saw that if it did not allow easy transport of spent fuel, Japan would simply develop its own reprocessing capability to the detriment of U.S. reprocessors. The new agreement gives blanket U.S. approval for shipments in return for much stronger

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THE U.S. AUTOMOTIVE PARTS MARKET AND JAPANESE COMPETITION

Summary

The selection of automotive parts as the subject of the second round of MOSS (market-oriented, sector-selective) negotiations has focused fresh attention on the trade impact of the close ties between Japanese motor vehicle manufacturers and their local suppliers. A strong case can be made that these relationships make it difficult for American companies to sell production parts to Japanese vehicle plants in the United States or replacement parts to the U.S. dealer networks of Japanese automotive makers. The same applies to the roadblocks domestic producers encounter in trying to crack the huge original equipment market in Japan. But there are signs that American suppliers of both original equipment and replacement products are starting to win more Japanese business in the United States, thanks in large part to the run-up in the yen's value but also because an expanding number of U.S. firms can match their Japanese competitors in terms of quality, price and other requirements.

Competitive Challenges for U.S. Suppliers

Unprecedented change, critical time -- phrases like those became the stock descriptions of the competitive pressures on the U.S. motor vehicle parts and accessories industry in the first half of the 1980s (see JEI Report No. 48A, December 21, 1984). Yet as rough as that period was for the 2,000 or so domestic companies that make production components and replacement parts, corporate executives and industry analysts say that it was just a preview of worse to come. The reasons are not hard to identify -- declining production by

Detroit, the Big Three's tougher supplier requirements and expanding purchases of foreign-made production parts, limited opportunities for export growth, the difficulties of selling service parts to Japanese automotive makers' U.S. dealer networks, the procurement practices of Japanese-affiliated vehicle assembly plants in this country and the influx of Japanese parts suppliers into the market. Forging a consensus on the ranking of these factors is another matter.

Lower output is the obvious candidate for top billing. Over the medium term production of cars and trucks in this country and Canada by U.S.-headquartered automotive manufacturers is unlikely to match 1986's total of 12.4 million vehicles -- itself 0.6 million units short of the year-earlier tally. The reason is simple: imports will continue to take sales away from domestic makes, particularly in the market's low end, whether American car and truck demand remains strong or weakens. Original equipment parts suppliers acknowledge that production anywhere near the 12-million-unit mark will translate into far more business than they had during the 1980-82 slump when North American motor vehicle output averaged just 8.9 million units a year. But their benchmark is the contract volume generated by 1978's all-time-high production run of 14.6 million units. By that standard there will not be enough business to support the already thinned ranks of independent OE suppliers.

Detroit's reduced parts requirements are just the most visible problem for these vendors. General Motors Corp., Ford Motor Co. and Chrysler Corp. have redrafted their criteria for contract awards, forcing suppliers to assume greater responsibility for quality improvement and cost containment while at the same time looking to them for more input in the new product design and development process. Industry executives admit that many outside suppliers will not be able to meet these stiff standards. But those that can stand a good chance of winning the multi-year single-source contracts that are increasingly replacing the Big Three's traditional year-to-year agreements with several companies to build the same part.

Competitive independents will benefit as well from the Big Three's slow but steady switch to outside suppliers, which currently provide perhaps 30 percent of GM's parts, approximately half of Ford's and an estimated two-thirds of Chrysler's. But as the U.S. industry learned years ago, not all of this business will stay in the United States. Contracts for labor-intensive parts will still go to suppliers in low-wage countries like Brazil, Mexico, Korea and Taiwan. At the same time Detroit will continue to source some powertrain products and other major mechanical components from firms in Japan, whether affiliates or unrelated companies, although the strong yen is expected to cap purchases at 1986's $1 billion-plus level.

In a double blow to domestic OE parts producers, the increase in car and truck production expected outside the United States and Canada during the late 1980s and early 1990s will not provide much additional business even though on paper the dollar's lower value should boost export volume. In Latin America and Southeast Asia, where most of the output gains will occur, governments continue to maintain import restrictions and other protective measures such as

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local content and export performance requirements to strengthen the manufacturing capability of local industry.

Neither is Europe likely to be a growth market for exporters of production parts since many American-designed components are already made there, either through licensing arrangements or by U.S. automotive manufacturers with European assembly operations. Ironically, Japan, which has always been written off as a closed market for domestic parts makers because of the structural relationships between Japanese original equipment producers and their suppliers, is perhaps the most promising source of new export business over the long haul. In the medium term, however, sales gains will remain modest; negotiating OE contracts, particularly for functional parts, is simply too time-consuming to show up quickly on order books.

With analysts projecting hard times ahead for the OE end of the business, growth in the $100 billion U.S. parts industry will hinge on its performance in the expanding domestic aftermarket. Here, at least, American producers have grounds for optimism, whether they are among the 50 percent of the industry making only replacement parts or the half that turns out both OE and service products. Even factoring in more import competition, domestic manufacturers will still control most sales of replacement parts for U.S.-built cars and trucks -- sales that make up roughly 85 percent of the aftermarket. They are also expected to remain the major suppliers of replacement parts for Japanese vehicles distributed through automotive repair shops, mass merchandisers and other nondealer channels.

These favorable market signs are all but ignored by domestic parts manufacturers. Instead, corporate executives return time and again to what they consider one of the major competitive challenges for the industry: the continued inability of American makers to break the near stranglehold of Japanese companies on the parts operations of franchised Japanese car and truck dealers in the United States. The fact that the dealer network handles well under 50 percent of the service and repair parts for Japanese vehicles is dismissed as irrelevant. What counts, say industry representatives, is that competitive American producers are denied access to the primary U.S. distribution channel for mechanical components and other high value-added products because they are locked out of the OE parts business in Japan. Elaborating, domestic makers point out that Japanese vehicle manufacturers, which generally have the final say in the parts sourcing decisions of their American dealers, tap the same companies that turn out production parts to supply genuine replacement parts to the aftermarket -- and these companies are almost always Japanese.

The U.S. industry has long blamed the inflow of replacement products from Japan for the huge bilateral trade deficit in motor vehicle parts and accessories, which totaled an estimated $4.2 billion in 1986 (see Table 1-3). In recent years, though, domestic suppliers have sounded the alarm over another challenge to their position -- the exclusionary OE procurement policies of Japanese car and truck assembly plants in this country. Actually, note industry leaders, this issue is the mirror image of the problem of selling production parts to Japanese automotive makers for use in their Japan-built vehicles: both have their origins in the close ties between Japanese original equipment manufacturers and their traditional Japanese parts suppliers.

Japan's U.S. Assembly Plants: Boon or Bane?

It is not hard to understand why domestic suppliers have taken aim at what they characterize as the exclusionary purchasing practices of the U.S. automotive assembly operations of Japanese corporations. In 1986 the three subsidiaries in production -- Honda of America Manufacturing, Inc., Nissan Motor Manufacturing Corp. U.S.A. and New United Motor Manufacturing Inc., a joint venture between Toyota Motor Corp. and General Motors -- turned out nearly 500,000 cars and just over 100,000 pickup trucks. In 1990, when the plants currently being built by Mazda Motor Manufacturing (USA) Corp., Diamond-Star Motors Corp. (the Mitsubishi Motors Corp.-Chrysler partnership), Toyota Motor Manufacturing, U.S.A. Inc. and Subaru-Isuzu Automotive Inc. (a tie-up between Fuji Heavy Industries, Ltd. and Isuzu Motors Ltd.) are onstream, Japanese motor vehicle manufacturers will have the capacity to produce 1,650,000 cars and trucks a year in the United States (see Table 4). Add in Honda Motor Co., Ltd.'s Canadian plant and the factories Toyota and a Suzuki Motor Co., Ltd.-GM joint venture are putting up in Canada and the figure hits 1,980,000 vehicles -- a major addition to North American production capacity under any circumstances but especially when many U.S.-headquartered vehicle makers are retrenching.

For American OE parts producers forced to cope with Detroit's production cutback, the expansion could not come at a better time. But there is a big catch, say domestic companies. Based on the track record of the three U.S. plants already in operation, Japanese automotive makers producing in North America will not source as high a percentage of their production parts requirements from local suppliers as they could, opting instead to bring in components from Japan or give their business to the Japanese parts manufacturers that follow them to the United States and Canada.

Measuring domestic content is an inexact science even using the Environmental Protection Agency's CAFE regulations or the language of various domestic content legislative proposals as a guideline, but the companies with plants under construction estimate that their vehicles at startup will have the same 50 to 60 percent local content that the cars and trucks assembled by Honda, Nissan and NUMMI now have. The U.S. parts industry scoffs at this figure, pointing out that its biggest component is labor. At most, it is calculated, the domestic parts content of vehicles built in this country is 20 percent. And that number, spokesmen add, is almost entirely made up of products like glass, paint, tires, seats, carpeting and plastic components -- in short, nonfunctional parts.

The major components brought in from Japan are powertrain products -- engines, transmissions and differentials or transaxles, which represent perhaps 30 percent of a vehicle's cost. These products have never been candidates for local sourcing simply because the design work is proprietary. Moreover, even in Japan, contracts for key powertrain componentry are not awarded to companies outside an automotive manufacturer's traditional group of suppliers. Executives of six of the seven Japanese assembly plants in operation or under construction in this country have also ruled out in-house production of engines and related products, saying that current or planned output levels (200,000 to 250,000 units a year) do not make this move cost effective.

The exception, to no one's surprise, is Honda, the pioneer in U.S. car production. In early January 1987 the company announced that it would invest

$450 million in its existing Ohio engine assembly plant to manufacture engine, drivetrain, suspension and brake assemblies for the 360,000 cars it expects to build here in coming years. When the factory reaches full operation in 1990, all the high value-added components for the Accord and Civic will be made in the United States. This will boost the domestic content of Honda vehicles to a projected 80 percent, or within striking range of the 90 percent-plus local content of the U.S. Big Three's current North American output, although Honda officials, adopting a conservative calculation method, are using the figure of 66 percent. It will also go a long way toward answering the labor movement's complaint that Japanese vehicle assembly plants in this country create only three parts-related jobs compared with 11 for American-owned facilities.

Honda's announcement is just the most visible sign that Japanese motor vehicle manufacturers are rethinking the purchasing policies of their U.S. subsidiaries. The same thing can be seen in the higher number of North American companies supplying the transplants, as they are called. Honda now has more than 60 major suppliers of production parts and materials compared with roughly 40 two years ago, while Nissan's OE supplier list has increased from 88 firms to 105 over the same period. For its part, NUMMI is buying production components and materials from 110 producers in the United States and Canada -- 40 or so more than at startup. Moreover, each of these companies as well as the firms with plants under construction emphasize that they are actively searching for additional OE vendors.

These statements are not ploys to silence the drumbeat of U.S. criticism about the low domestic parts content of their vehicles. More fundamental factors are at work. The obvious one is the strong yen, which has not only wiped out the cost advantage of components sourced from Japan but in many cases given American suppliers a substantial edge. At the same time, an increasing number of U.S. parts producers can meet the transplants' two other primary criteria for domestic sourcing -- quality at least equal to that of the Japanese competitor on a sustained basis and timely delivery. Ironically, some of the credit for this change goes to Detroit and its stiffer purchasing standards. Most, however, reflects the new willingness of American companies to learn the requirements of Japanese customers and make the necessary adjustments in their product, manufacturing process or way of doing business.

While applauding the expansion in local sourcing, both U.S. government and industry officials are worried about a parallel development: Japanese parts manufacturers coming to this country either to supply their traditional customers or Detroit. Concern about this trend is not new, but the attention given it has increased in line with each new report that another Japanese supplier was locating here. In fact, a recent survey by the Japan Economic Institute identified 76 Japanese-affiliated motor vehicle parts and accessories plants in operation or under construction at the end of 1986 (see Table 5) compared with 31 two years earlier. (Plants were only listed if their output is sold exclusively to original equipment automotive manufacturers or aftermarket distributors.)

People in the domestic industry maintain that the upsurge in Japanese investment in U.S. parts plants could represent the biggest challenge yet to the competitive position of American suppliers. The industry already has excess capacity, they argue, and the arrival of new Japanese producers will only make a bad situation worse. But their criticism is not reserved for the competition. Japanese original equipment manufacturers also get a large part of the blame for encouraging their traditional suppliers, however indirectly, to follow them to the United States.

Faced with this rising backlash, parts suppliers in Japan have started to go on the offensive. Their industry is in a bind of its own, spokesmen say, as vehicle manufacturers build up offshore capacity and the strong yen makes exporting more difficult. Representatives add that even with incentives from state or local governments and some assurance of business from the transplants or Detroit, investing in the United States is not a risk-free move for Japan's predominantly small parts companies. If nothing else, the pressure on Japanese vehicle assembly plants here for greater sourcing from American suppliers could cost Japanese parts producers with U.S. facilities future contracts.

Even with more domestic suppliers tying up with Japanese companies to manufacture parts in this country, the debate over the competitive impact of Japanese-affiliated plants will not end anytime soon. One key to its staying power is the fact that Japanese parts producers continue to move into the market. Firm plans have already been announced for eight additional plants, while a long list of other companies is known to be looking for production sites.

One unfortunate side effect of this dispute is that it has overshadowed perhaps the single most promising piece of news for the beleaguered U.S. industry: the rising numbers of American companies serving as suppliers to Japanese vehicle assembly plants in the United States are in a good position to sell parts to original equipment manufacturers in Japan and to break into the dealer-controlled aftermarket for Japanese cars and trucks. This, after all, has always been the long-term objective.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: U.S. Trade in Motor Vehicle Parts and Accessories, 1980-86

(in thousands of dollars; exports f.a.s. value, imports Customs value basis)

	1980	1981	1982	1983	1984	1985	Ten Months 1985	Ten Months 1986
				Overall Trade Balance				
Total Exports	$9,307,157	$11,261,660	$10,641,745	$11,045,088	$13,836,159	$14,270,471	$12,147,175	$10,798,839
Total Imports	9,025,010	8,447,409	9,112,226	12,597,206	16,980,573	18,947,124	15,652,762	17,515,441
Trade Balance	282,147	2,814,251	1,529,519	-1,552,118	-3,144,414	-4,676,653	-3,505,587	-6,716,602
				U.S.-Japan Trade Balance				
Exports to Japan	105,209	118,991	127,847	148,368	179,205	203,634	168,221	185,548
Imports from Japan	2,828,725	1,821,699	1,822,344	2,112,954	2,939,927	3,470,429	2,850,465	3,708,455
Trade Balance	-2,723,516	-1,702,708	-1,694,497	-1,964,586	-2,760,722	-3,266,795	-2,682,244	-3,522,907
				Major Export Markets				
Canada	5,119,372	6,194,440	6,382,881	7,722,027	9,680,280	9,766,120	8,363,303	7,075,354
Mexico	1,377,352	1,904,878	1,115,443	764,725	1,365,460	1,865,125	1,560,902	1,453,200
Venezuela	392,010	536,269	524,329	278,384	410,784	336,248	290,311	288,279
West Germany	156,795	221,238	226,741	219,880	244,103	282,010	237,624	226,931
United Kingdom	190,198	210,359	196,209	200,293	228,182	216,385	185,078	190,075
Japan	105,209	118,991	127,847	148,368	179,205	203,634	168,221	185,548
Australia	209,274	237,944	223,673	153,499	226,008	232,243	189,884	141,084
Saudi Arabia	158,770	223,230	266,011	225,365	208,169	157,932	136,228	105,849
Belgium	140,547	115,108	135,357	124,750	94,246	97,078	83,753	92,715
Brazil	n.a.	49,864	51,327	57,454	60,186	94,117	77,743	85,051
				Major Import Suppliers				
Canada	3,379,057	3,896,053	4,524,980	6,568,970	8,728,217	9,347,295	7,875,973	7,781,461
Japan	2,828,725	1,821,699	1,822,344	2,112,954	2,939,927	3,470,429	2,850,465	3,708,455
Mexico	310,339	418,957	648,003	1,207,665	1,552,027	2,058,760	1,629,353	1,886,791
West Germany	797,327	586,035	506,679	631,396	849,243	995,238	784,367	1,168,707
Brazil	222,706	247,426	310,457	424,085	582,848	689,448	556,370	618,127
France	453,734	390,211	294,501	323,594	453,036	481,308	396,244	494,116
United Kingdom	299,852	260,871	189,526	232,457	359,765	383,162	308,825	392,517
Taiwan	110,084	118,120	133,820	248,446	329,339	316,767	265,715	323,109
Korea	120,313	163,625	189,234	254,088	347,103	352,036	298,808	283,270
Italy	140,098	147,523	123,524	130,708	182,088	205,835	165,025	228,559

Source: U.S. International Trade Commission, unpublished data

Table 2: U.S. Exports of Motor Vehicle Parts and Accessories to Japan, 1980-86

(in thousands of dollars, f.a.s. value basis)

	1980	1981	1982	1983	1984	1985	Ten Months 1986
Total	$105,209	$116,991	$127,847	$148,368	$179,205	$203,634	$185,548
Bodies	0	350	260	266	111	245	351
Chassis	1,074	106	106	84	66	192	208
Axles	n.a.	438	1,025	9,696	1,558	451	560
Body Stampings	284	107	124	93	246	121	53
Bumpers	83	162	0	0	0	0	0
Wheels	962	620	1,196	1,107	1,049	725	954
Hubcaps and Wheel Covers	71	227	0	0	0	0	0
Radiators	77	366	319	277	71	0	0
Mufflers and Tailpipes	108	0	0	0	226	280	0
Brakes and Parts	4,545	4,275	3,832	4,487	6,022	4,767	5,752
Shock Absorbers	617	678	510	793	1,124	639	272
Transmissions	17,955	17,301	16,316	18,775	23,496	25,609	17,583
Parts Not Listed Above	33,678	32,179	31,678	33,585	67,992	97,227	93,455
Engines	469	1,354	1,191	1,350	3,263	4,573	3,027
Engine Parts	18,704	26,873	32,479	38,036	30,037	27,473	16,904
Ignition Wiring Sets*	554	698	696	640	676	867	820
Starter Motors	105	189	487	505	370	360	229
Spark Plugs	1,149	760	920	618	569	271	665
Points	0	0	0	0	0	0	0
Battery Chargers	141	214	245	117	385	79	59
Lead-Acid Storage Batteries*	1,067	1,488	1,513	2,007	2,178	2,095	2,460
Voltage Regulators*	93	137	112	82	146	144	163
Other Starting and Ignition Equipment	906	587	900	631	701	585	665
Lighting Equipment	350	395	507	272	286	169	460
Sealed Beams	2,326	2,592	4,186	4,314	4,177	2,802	2,248
Signaling Equipment	417	0	0	0	0	0	119
Pumps	857	552	243	156	260	82	132
Fans and Blowers	0	73	0	70	0	0	0
Air Conditioners	3,126	2,965	1,040	1,114	589	899	753
Air Conditioner Compressors	n.a.	n.a.	91	115	78	97	86
Springs and Leaves	0	0	0	0	0	0	0
Hinges and Other Hardware	610	529	575	658	774	740	1,385
Locks	0	0	0	0	0	113	153
Furniture*	603	2,179	2,729	1,196	1,897	999	1,041
Tempered Glass	350	138	120	81	95	0	76
Laminated Glass	1,091	3,096	3,530	5,226	7,569	5,469	6,564
Mirror Glass	0	0	0	0	0	0	0
Radios	839	0	139	123	455	461	1,002
Tires	6,147	11,039	12,295	11,034	8,780	9,020	14,883

*Not all necessarily for motor vehicles.

Source: U.S. Department of Commerce, Bureau of the Census, U.S. Exports: Schedule E Commodity by Country (FT 410)

Table 3: U.S. Imports of Motor Vehicle Parts and Accessories from Japan, 1980-86

(in thousands of dollars, Customs value basis)

	1980	1981	1982	1983	1984	1985	Ten Months 1986
Total	$2,828,725	$1,821,699	$1,822,344	$2,112,954	$2,939,927	$3,470,429	$3,708,455
Compact Truck Bodies (incl. cabs)	206,923	31,339	20,291	9,296	12,451	58,966	75,649
Other Bodies	2,989	0	674	302	24,643	81,617	29,390
Compact Truck Chassis	1,237,310	0	0	0	1,042	1,119	2,635
Other Chassis	7,248	0	1,235	4,001	8,644	20,091	43,347
Body Stampings	55,178	67,544	69,235	69,689	92,804	117,699	114,689
Bumpers	14,678	16,307	18,127	18,885	30,375	40,606	45,152
Axle Spindles	0	0	5,771	703	22,259	33,328	47,646
Wheels	5,710	7,614	7,935	15,204	27,157	60,057	77,337
Hubcaps and Wheel Covers	1,075	1,993	980	1,873	3,466	4,453	4,167
Radiators	2,992	3,770	4,754	4,446	9,618	14,244	17,561
Mufflers and Tailpipes	10,669	10,561	9,569	17,322	16,766	21,935	30,139
Brakes and Parts	18,882	25,263	25,332	31,466	43,289	57,024	65,414
Shock Absorbers	6,844	11,152	12,199	15,538	21,924	24,283	20,252
Transmissions	36,405	44,513	81,671	122,957	124,762	159,069	226,999
Parts Not Listed Above	197,217	268,536	274,069	356,917	612,178	748,942	800,156
Diesel Engines	9,511	31,945	22,845	12,448	19,180	9,615	8,668
Gasoline Engines	87,788	106,598	116,795	66,460	128,125	121,532	113,787
Engine Parts	118,455	142,331	107,331	117,559	152,621	179,273	178,444
Ignition Wiring Sets*	2,890	3,312	4,331	6,486	11,291	11,803	20,480
Starter Motors	16,459	23,571	19,486	25,958	36,591	43,563	43,262
Spark Plugs	16,216	13,674	15,638	18,164	24,281	29,428	24,250
Points	4,625	3,637	2,392	2,449	2,644	2,024	1,697
Battery Chargers	7,158	8,424	8,486	10,468	17,071	22,998	23,770
Lead-Acid Storage Batteries*	12,736	11,372	12,786	14,751	19,510	29,049	27,037
Voltage Regulators*	3,216	4,218	4,588	4,693	7,757	4,038	6,091
Other Starting and Ignition Equipment*	26,313	27,081	25,440	31,100	49,403	61,003	95,470
Speedometers and Tachometers*	11,303	13,733	11,069	14,934	23,955	23,647	24,228
Lighting Equipment	25,796	26,136	28,646	34,176	42,829	53,226	58,013
Sealed Beams	2,030	1,412	1,075	904	878	1,174	1,416
Pumps	15,156	20,754	16,610	22,608	35,273	44,834	53,062
Fans and Blowers	3,992	4,746	10,735	4,491	5,947	7,996	12,371
Air Conditioners and Parts	n.a.	n.a.	n.a.	51,207	71,704	142,107	138,634
Air Conditioner Compressors	n.a.	n.a.	39,464	70,610	103,233	130,284	141,456
Springs and Leaves	4,699	6,435	4,707	9,292	16,630	15,987	14,205
Hinges	6,899	8,238	9,464	14,315	25,368	28,492	26,919
Locks	2,627	2,860	3,237	3,318	5,462	5,341	7,063
Furniture	6,384	7,794	9,743	11,189	18,101	38,271	56,054
Tempered Glass*	6,936	7,117	8,070	8,271	13,307	14,022	16,049
Laminated Glass	2,479	2,584	2,788	3,544	6,066	6,166	13,765
Radios	45,483	36,442	34,387	27,769	27,632	38,222	29,854
Radio-CB Combinations	1,911	300	173	268	105	195	326
Tape Players	27,691	50,977	48,415	61,934	50,337	46,022	53,890
Radio-Tape Player Combinations	288,476	384,959	341,324	356,472	451,351	524,973	468,277
Tires	214,345	302,805	309,985	343,026	425,952	466,947	394,833

*Not all necessarily for motor vehicles.

Source: U.S. Department of Commerce, Bureau of the Census, U.S. Imports for Consumption and General Imports (FT 246)

Table 4: Japanese Investment in U.S. Automotive Assembly Facilities

Parent	Share	Subsidiary	Location	Product Line	Start Date	Annual Capacity	Employment	Investment (millions)	Comments
Honda Motor Co., Ltd.	100%	Honda of America Manufacturing, Inc.	Marysville, OH	Compact cars Subcompact cars	November 1982 July 1986	320,000 360,000 (1988)	3,700	$615	Stamping plant makes all exterior body panels and major interior structural panels for Accord and Civic. Plastics plant makes Accord bumpers and dashboards. Some Civic engines assembled at Anna, Ohio plant (see Table 5). Current output mix: three Accords to two Civics.
Nissan Motor Co., Ltd.	100%	Nissan Motor Manufacturing Corp. U.S.A.	Smyrna, TN	Compact pickups Subcompact cars	June 1983 March 1985	240,000	3,300	$848	All sheet metal parts for trucks and cars stamped at plant except truck frames. Current output mix: two Sentras for every pickup.
Toyota Motor Corp. General Motors Corp.	50% 50%	New United Motor Manufacturing Inc.	Fremont, CA	Subcompact cars	December 1984	250,000	2,600	$450	Stamping plant makes all sheet metal parts for Chevrolet Nova. Started assembling Corolla FX 16 for sale by Toyota Motor Sales U.S.A. Inc. in September 1986. FX currently being produced at annual rate of 35,000 units.
Mazda Motor Corp.	100%	Mazda Motor Manufacturing (USA) Corp.	Flat Rock, MI	Compact cars	September 1987	240,000 (fall 1988)	3,500 (fall 1988)	$550*	All exterior sheet metal parts will be stamped at the plant. Some plastic components will also be made. Two cars will be turned out: a 626-class model for Mazda and a sporty two-door model built on the same platform for Ford Motor Co. The Mazda model will account for 40 to 50 percent of output.
Mitsubishi Motors Corp. Chrysler Corp.	50% 50%	Diamond-Star Motors Corp.	Bloomington-Normal, IL	Subcompact cars	November 1988	240,000 (1990)	2,900 (1990)	$700*	Stamping plant will make all exterior body panels for MMC-designed "sports specialty" car. Some plastic parts will also be molded in-house. Output will be split equally between the partners.
Toyota Motor Corp.	100%	Toyota Motor Manufacturing, U.S.A. Inc.	Georgetown, KY	Compact cars	1988	200,000 (1989)	3,000 (1989)	$800*	All exterior body components for 2,000cc Camry-class car will be stamped at plant. A plastics plant will make bumpers and interior components.
Fuji Heavy Industries, Ltd. Isuzu Motors ltd.	51% 49%	Subaru-Isuzu Automotive Inc.	Lafayette, IN	Subcompact cars Compact pickups	November 1989	120,000 (1990)	1,700 (1990)	$500*	Will have stamping plant. Output will be split equally between the two companies. FHI will make sedans and station wagons for sale by Subaru of America Inc.; Isuzu will produce P'UP pickups.

*Projected

Table 5: U.S. Production of Motor Vehicle Parts and Accessories by Japanese-Affiliated Companies

Company	Parent	Share	Plant Location	Year Operational	Product Line	Comments
*AMBRAKE Corp.	Akebono Brake Industry Co., Ltd. General Motors Corp.	50% 50	Elizabethtown, KY	1988	Disc and drum brake assemblies and components	Will be selling in both OE and aftermarket.
AMTEX Inc.	Hayashi Telempu Co., Ltd. C.H. Masland & Sons	50 50	Manteca, CA	1986	Floor and trunk mats; door trim and other interior trim products	Primarily OE supplier to New United Motor Mfg. Inc. but also sells in aftermarket.
AP Technoglass Corp.	Asahi Glass Co., Ltd. PPG Industries, Inc.	80 20	Bellefontaine, OH	1986	Safety glass	Output goes to Belletech Corp. (see below).
ASTRONET Corp.	Mitsubishi Electric Corp. Mitsubishi Corp. Plessey Co., Plc	25 24 51	Lake Mary, FL	1984	Cellular mobile communications equipment	Aftermarket supplier.
ATR Wire and Cable Co.	Tokyo Rope Manufacturing Co., Ltd. Mitsubishi Corp. C. Itoh & Co., Ltd.	60 20 20	Danville, KY	1981	Steel cord and bead wire for tires	Output goes to American tire manufacturers.
*Aisin U.S.A. Inc.	Aisin Seiki Co., Ltd.	100	Seymour, IN	1988	Mechanical and other components	Will be OE supplier to both the U.S. production units of Japanese companies and American producers.
Alpine Electronics Manufacturing of America Inc.	Alps Electric Co., Ltd.	100	Greenwood, IN	1987	AM/FM radio-cassette combinations; switches	OE supplier to BMW of North America Inc. and Honda of America Mfg., Inc. Replaces a smaller California plant that went into operation in 1984.
*Asmo Manufacturing Inc.	Asmo Co., Ltd.	100	Battle Creek, MI	1987	Plastic parts for windshield washers	Output will go to Nippondenso Manufacturing U.S.A., Inc. (see below).
Bellemar Parts Industries Inc.	Honda Motor Co., Ltd. Sankei Giken Kogyo Co., Ltd. Tokyo Seat Co., Ltd.	80 10 10	Marysville, OH	1982	Seat assemblies and steel wheels	OE supplier to Honda of America Mfg., Inc.
Bellemar Parts Industries Inc.	Honda Motor Co., Ltd. Sankei Giken Kogyo Co., Ltd. Tokyo Seat Co., Ltd.	80 10 10	Russells Point, OH	1985	Exhaust systems, catalytic converters, brake lines, door sashes and seat frames	OE supplier to Honda of America Mfg., Inc.
Belletech Corp.	Asahi Glass Co., Ltd. Takahashi Glass Industry Co., Ltd. PPG Industries, Inc.	60 20 20	Bellefontaine, OH	1986	Glass fittings	Assembles windows and windshields from glass supplied by AP Technoglass Corp. Output goes to Honda of America Mfg., Inc.
*Bloomington Seating Co.	Namba Press Works Co., Ltd. Douglas & Lomason Co.	50 50	Normal, IL	1988	Seats	Will be OE supplier to Diamond-Star Motors Corp.

Company	Parent	Share	Plant Location	Year Operational	Product Line	Comments
Bridgestone (USA) Inc.	Bridgestone Corp.	100	LaVergne, TN	1982	Radial tires for heavy-duty trucks and buses	Sells primarily in replacement market but some tires go into OE market. Makes tires for sale under own name as well as for Firestone Tire & Rubber Co. Production of car tires under consideration.
CKR Industries, Inc.	Kinugawa Rubber Industrial Co., Ltd. Chardon Rubber Co.	45 55	Winchester, TN	1986	Rubber and plastic weather stripping	OE supplier to Nissan Motor Mfg. Corp. U.S.A.
Calsonic, Inc.	Nihon Radiator Co., Ltd.	100	Irvine, CA	1976	Air conditioning systems	OE supplier to Nissan Motor Corp. U.S.A. Units are sent to seven Nissan port facilities around the country where they are installed in imported vehicles or to 12 parts depots from which Nissan dealers get supplies.
Calsonic Manufacturing Corp.	Nihon Radiator Co., Ltd.	100	Shelbyville, TN	1983	Air conditioning systems, exhaust assemblies and engine cooling systems	OE supplier to Nissan Motor Mfg. Corp. U.S.A.
Cast Forge Co.	Nippon Light Metal Co., Ltd. Kelsey-Hayes Co.	20 80	Howell, MI	1982	Aluminum wheels, transmission component parts and engine parts	Output goes to OE makers.
*Central Manufacturing Co.	Central Motor Wheel Co., Ltd. Toyoda Tsusho Kaisha Ltd. Kelsey-Hayes Co.	40 20 40	Paris, KY	1988	Steel and aluminum wheels	Will be OE supplier to both the U.S. production units of Japanese companies and American makers.
Clarion Manufacturing Corp. of America	Clarion Co., Ltd.	100	Walton, KY	1987	AM/FM radio-cassette combinations and AM/FM radio receivers	OE supplier to Nissan Motor Mfg. Corp. U.S.A. Also supplies Subaru of America Inc. dealers.
Curtis-Maruyasu America, Inc.	Maruyasu Industries Co., Ltd. Curtis Products, Inc.	50 50	Tracy, CA	1985	Fuel line and hydraulic brake assemblies	OE supplier to New United Motor Mfg. Inc.
Dunlop Tire Corp.	Sumitomo Rubber Industries, Ltd.	98	Huntsville, AL Buffalo, NY	1986	Radial and belted tires for cars and radial and bias tires for light- and medium-duty trucks	OE supplier to Honda of America Mfg., Inc., General Motors Corp.'s truck and bus division and other U.S. truck and trailer manufacturers. Dunlop brand car and truck replacement tires marketed through national base of independent dealers and distributors.
Dunlop Tire Corp.	Sumitomo Rubber Industries, Ltd.	98	Utica, NY	1986	Tire cord	Output goes to two Dunlop tire manufacturing plants.

Company	Parent	Share	Plant Location	Year Opera- tional	Product Line	Comments
*Enkenei America Inc.	Enshu Keigokin Co., Ltd. Mitsubishi Corp.	60 40	Columbus, IN	1987	Aluminum wheels	Will primarily be OE supplier to American companies but expects some sales in aftermarket.
Fuji Koki America Inc.	Fuji Koki Manufacturing Co., Ltd.	100	Dallas, TX	1982	Expansion valves for air conditioning systems	OE supplier to U.S. manufacturing affiliates of Japanese companies as well as American producers.
Fujitsu America, Inc.	Fujitsu, Ltd.	100	Richardson, TX	1984	Cellular mobile communications equipment	Aftermarket supplier.
*Fujitsu Ten America Inc.	Fujitsu Ten Ltd.	100	Rushville, IN	1987	AM/FM radio-cassette combinations, AM/FM radio receivers and cassette decks	Will be OE supplier to both the American production units of Japanese companies and U.S. makers. Will also supply aftermarket.
*Greenville Technology Inc.	Moriroku Co., Ltd.	100	Greenville, OH	1987	Plastic parts	Will be OE supplier to Honda of America Mfg., Inc.
Hi-Lex Corp.	Nippon Cable System, Inc.	100	Battle Creek, MI	1978	Control cables for accelerators, clutches, hood and trunk release mechanisms, gas filler lids and brakes	Has OE contracts with General Motors Corp., Ford Motor Co., Chrysler Corp. and Nissan Motor Mfg. Corp. U.S.A. Some output also goes to replacement market.
*Hisan Inc.	Sanoh Industrial Co., Ltd. ITT Higbie Manufacturing Co.	50 50	Archbold, OH	1987	Fuel and brake lines	Will be OE supplier to the U.S. manufacturing affiliates of Japanese companies.
Hitachi Automotive Products (USA) Inc.	Hitachi, Ltd.	100	Harrodsburg, KY	1986	Electronic engine control units, ignition coils, pressure sensors, idle speed control valves, starters and alternators	OE supplier to both the U.S. production subsidiaries of Japanese companies and American producers.
Honda of America Manufacturing, Inc.	Honda Motor Co., Ltd.	100	Anna, OH	1986	Engines and aluminum wheels	Currently assembles Civic engines at an annual rate of about 60,000 units. In early January 1987 Honda announced that it would invest $450 million in the plant for the production of engine, drive train, suspension and brake assemblies for the Accord and Civic. When full-scale production is reached in 1990, the plant will be able to make 360,000 engines a year.

Company	Parent	Share	Plant Location	Year Operational	Product Line	Comments
Izumi Corp.	Izumi Motor Co., Ltd.	100	Yaphank, NY	1979	Steering wheels and horn pad assemblies	OE supplier to Chrysler Corp., Ford Motor Co., General Motors Corp. and most foreign companies with U.S. production facilities. Opened urethane manufacturing plant in 1986.
Jideco of Bardstown, Inc.	Jidosha Denki Kogyo Co., Ltd.	100	Bardstown, KY	1987	Windshield wiper motors and automatic speed control devices	Has OE contract with Nissan Motor Mfg. Corp. U.S.A.
KTH Parts Industries Inc.	Kikuchi Press Kogyo Co., Ltd. Takao Kinzoku Kogyo Co., Ltd. Hirata Press Kogyo Co., Ltd. Hongo Seisakusho Co., Ltd.	n.a. n.a. n.a. n.a.	St. Paris, OH	1985	Stamped and welded internal structural components	OE supplier to Honda of America Mfg., Inc.
Kantus Corp.	Kanto Seiki Co., Ltd.	100	Lewisburg, TN	1985	Plastic instrument panels, radiator grilles, console and glove boxes, bumpers and splash guards	OE supplier to Nissan Motor Mfg. Corp. U.S.A. Will add urethane foam operation in summer of 1987 to make foam pads for instrument panels.
Kux Manufacturing Co.	Mitsubishi Corp.	100	Detroit, MI	1985	Self-adhesive lettering and decals	Output goes mainly to General Motors Corp.
Matsushita Communication Corp. of America	Matsushita Communication Industrial Co., Ltd. Matsushita Electric Industrial Co., Ltd.	50 50	Franklin Park, IL	1984	Cellular mobile communications equipment	Aftermarket supplier.
*Matsushita Communication Corp. of America	Matsushita Communication Industrial Co., Ltd. Matsushita Electric Industrial Co., Ltd.	50 50	Peachtree City, GA	1987	AM/FM radio-cassette combinations and AM/FM radio receivers	Will supply OE market.
Mitsubishi Consumer Electronics America, Inc.	Mitsubishi Electric Corp.	100	Braselton, GA	1986	Cellular mobile communications equipment	Aftermarket supplier.
Musashi USA Inc.	Musashi Precision Industry Co., Ltd.	100	Battle Creek, MI	1985	Arm bushing and joint assemblies	OE supplier to Ford Motor Co.
NEC America, Inc.	NEC Corp.	100	Hillsboro, OR	1985	Cellular mobile communications equipment	Aftermarket supplier.
NGK Spark Plugs (U.S.A.), Inc.	NGK Spark Plug Co., Ltd.	100	Irvine, CA	1977	Spark plugs	Output goes into replacement market for both imported and domestically made vehicles.
*NHK-Associated Spring Suspension Components Inc.	NHK Spring Co., Ltd. Barnes Group Inc.	55 45	Bowling Green, KY	1987	Coil suspension springs	Expects initially to be OE supplier to Japanese auto makers with U.S. facilities.
NOK Inc.	NOK Corp.	100	LaGrange, GA	1980	Oil and mechanical seals	Has OE contracts with General Motors Corp., Ford Motor Co., Chrysler Corp., American Motors Corp. and Navistar International Corp. Also supplies aftermarket.

Company	Parent	Share	Plant Location	Year Operational	Product Line	Comments
Neaton Auto Products Manufacturing Inc.	Nihon Plast Co., Ltd.	100	Eaton, OH	1985	Steering wheels and other plastic interior decorative parts	OE supplier of steering wheels to Honda of America Mfg., Inc. and Nissan Motor Mfg. Corp. U.S.A. Decorative parts go to Honda.
*New Sabina Industries Inc.	Nippon Seiki Co., Ltd.	100	Sabina, OH	1987	Instrument clusters (speedometer, tachometer, fuel gauge and temperature gauge)	Will primarily be OE supplier to Honda of America Mfg., Inc.
Nippondenso of Los Angeles Inc.	Nippondenso Co., Ltd.	100	Long Beach, CA	1971	Air conditioning systems	Has OE contract with New United Motor Mfg. Inc. Also supplies units to the dealer networks of Toyota Motor Corp. and other Japanese motor vehicle makers. Remanufactures starters, alternators and electronic parts.
Nippondenso Manufacturing U.S.A., Inc.	Nippondenso Co., Ltd.	100	Battle Creek, MI	1986	Heat exchangers, evaporators and condensers for air conditioners, windshield washers, heaters and radiators	Air conditioner parts shipped to Nippondenso of Los Angeles Inc. (see above) for assembly. Other products go to Honda of America Mfg., Inc. Another Nippondenso Co., Ltd. unit made windshield washers and heaters in Battle Creek from 1983 until this plant came onstream.
*Nishikawa Standard Co.	Nishikawa Rubber Co., Ltd. Standard Products Co.	60 40	Topeka, IN	1987	Rubber weather stripping	Expects to be primarily OE supplier to the U.S. production units of Japanese makers.
North American Lighting Inc.	Koito Manufacturing Co., Ltd. Ichikoh Industries Ltd. Hella K.G. Hueck & Co.	39 10 51	Flora, IL	1983	Front and park lamps, rear combination lamp assemblies, fog lamps, license-plate lamps, high-mounted stop lamps and aerodynamic lamps	OE supplier to Nissan Motor Mfg. Corp. U.S.A., BMW of North America Inc., Volkswagen of America, Inc., Ford Motor Co., General Motors Corp. and Chrysler Corp.
*Ogihara America Corp.	Ogihara Iron Works Co., Ltd.	100	Howell, MI	1987	Body stampings	Will be OE supplier to Ford Motor Co.
Oki America Inc.	Oki Electric Industry Co., Ltd.	100	Norcross, GA	1984	Cellular mobile communications equipment	Aftermarket supplier.
PEP Industries Inc.	Fujikura Ltd. Aluminum Co. of America	49 51	Houston, MS Ripley, MS Nashville, TN	1986	Wire harnesses	Primarily OE supplier to Ford Motor Co.
*Penstone Inc.	Ishizaki Honten Co., Ltd. Nippon Sheet Glass Co., Ltd.	70 30	Rockwood, MI	1987	Safety glass	Will be OE supplier to Mazda Motor Mfg. (USA) Corp.

Company	Parent	Share	Plant Location	Year Operational	Product Line	Comments
Pioneer Industrial Components Inc.	Pioneer Electronic Corp.	100	Springboro, OH	1986	AM/FM radio-cassette combinations	Primarily OE supplier to both the U.S. manufacturing affiliates of Japanese companies and American producers, although does supply some units to the aftermarket.
Sanden International (USA), Inc.	Sanden Corp.	100	Dallas, TX	1980	Compressors, compressor clutches and evaporators for air conditioning systems	Sells in both OE market and aftermarket to American manufacturers and the U.S. production affiliates of Japanese companies.
Service Spring Co.	Toyoshima Special Steel Co., Ltd.	100	Indianapolis, IN	1986	Leaf springs	Sells mainly in the aftermarket but does do some OE business.
Sheller-Ryobi Corp.	Ryobi Ltd. Sheller-Globe Corp.	55 45	Shelbyville, IN	1986	Aluminum transmission cases	OE supplier to General Motors Corp. and Ford Motor Co.
*Showa Aluminum Corp. of America	Showa Aluminum Corp.	100	Mt. Sterling, OH	1987	Heat exchangers, evaporators and condensers for air conditioning systems	Will be OE supplier.
*I.I. Stanley Co., Inc.	Stanley Electric Co., Ltd. Kyokuto Boeki Kaisha Ltd.	70 30	Battle Creek, MI	1987	Electrical components	Expects to be OE supplier to both the U.S. manufacturing affiliates of Japanese companies and American makers.
Stanley Electric U.S. Co., Inc.	Stanley Electric Co., Ltd.	100	London, OH	1982	Front combination lamp assemblies, head lamps, front turn signal lamps, tail lamps and license plate lamps	OE supplier to Honda of America Mfg., Inc.
*Sumitomo Electric Wiring Systems Inc.	Sumitomo Electric Industries, Ltd. Sumitomo Wiring Systems, Ltd.	60 40	Morgantown, KY	1987	Wire harnesses	Will initially be OE supplier to the American production units of Japanese companies.
TG (U.S.A.) Corp.	Toyoda Gosei Co., Ltd. Mitsui & Co., Ltd.	80 20	Perryville, MO	1987	Steering wheels and governor gears	Has OE contracts with two of the U.S. Big Three companies. Also expects to supply the American production units of Japanese companies. With the completion of phase two by late summer 1987, the company will be producing a variety of plastic interior and exterior parts.
*Tokai Corp.	Tokai Rubber Industries, Ltd.	100	Livonia, MI	1987	Anti-vibration rubber engine mounts	Will be OE supplier to Ford Motor Co.
*Tomasco Mulciler Inc.	Masuda Manufacturing Co., Ltd.	100	Columbus, OH	1987	Stamped parts	Will be OE supplier to Honda of America Mfg., Inc.
Topy Corp.	Topy Industries, Ltd.	100	Frankfort, KY	1986	Steel wheels	OE supplier to Nissan Motor Mfg. Corp. U.S.A. and Honda of America Mfg., Inc.

Company	Parent	Share	Plant Location	Year Operational	Product Line	Comments
Toyota Auto Body Inc. of California	Toyota Motor Corp.	100	Long Beach, CA	1974	Cargo beds for pickup trucks	OE supplier to Toyota Motor Sales U.S.A. Inc. Beds shipped to eight Toyota port facilities around the United States where they are mounted on imported cab-chassis units.
Tri-Con Industries, Ltd.	Tokyo Seat Co., Ltd.	100	Columbia, MO	1983	Seats	Has OE contract with Chrysler Corp. Also has car seat sewing plant in Cape Girardeau, Missouri.
Tri-Con Industries, Ltd.	Tokyo Seat Co., Ltd.	100	Lincoln, NE	1985	Seat frames	Output goes to Tri-Con seat plant.
*United Globe Nippon, Inc.	Nihon Tokushu Toryo Co., Ltd.] Hirotoni Co., Ltd.] Fujiiyoshi & Co., Ltd.] Globe Industries, Inc.	 50 50	Chicago Heights, IL	1987	Sound control products; package shelf, trunk and other trim products; and rustproof and anti-chip coatings	Will be OE supplier to the U.S. production plants of Japanese companies.
*United L-N Glass, Inc.	Nippon Sheet Glass Co., Ltd. Libbey-Owens-Ford Co.	50 50	Versailles, KY	1987	Safety glass	Will be OE supplier to Toyota Motor Mfg., U.S.A. Inc.
VDO-YAZAKI Corp.	Yazaki Corp. VDO Adolf Schindling AG	50 50	Winchester, VA	1986	Speedometers, tachometers, fuel gauges, temperature gauges and instrument clusters	Mainly OE supplier to American makers.
Viam Manufacturing Inc.	Japan Vilene Co., Ltd. Dainippon Ink & Chemicals Inc.	60 40	Santa Fe Springs, CA	1984	Floor mats	Currently sells in just OE market but expects to begin selling in the aftermarket.
Warner-Ishi Corp.	Ishikawajima-Harima Heavy Industries Co., Ltd. Borg-Warner Corp.	50 50	Shelbyville, IL	1985	Turbochargers	OE and aftermarket supplier.
Wynn-Kiki Inc.	Diesel Kiki Co., Ltd. Wynn Industries, Inc.	50 50	Fort Worth, TX	1984	Condensers, evaporators and tube assemblies for air conditioning systems	Sells primarily in OE market to both American manufacturers and U.S. manufacturing affiliates of Japanese companies. Some sales of replacement parts.
*Woodbridge INOAC Inc.	Inoue MTP Co., Ltd. Woodbridge Foam Corp.	49 51	Bardstown, KY	1988	Plastic instrument panels, body side moldings and other rubber, urethane and plastic products	Expects to be OE supplier to the American production units of Japanese companies and U.S. producers.

*Under construction.

Product Guide

Air Conditioning Systems
Calsonic, Inc.
Calsonic Manufacturing Corp.
Nippondenso of Los Angeles Inc.

Air Conditioning System Parts
Fuji Koki America Inc.
Nippondenso Manufacturing U.S.A., Inc.
Sanden International (USA), Inc.
Showa Aluminum Corp. of America
Wynn Kiki Inc.

Brakes and Fuel Lines
Bellemar Parts Industries Inc.
Curtis-Maruyasu America, Inc.
Hisan Inc.

Brakes
AMBRAKE Corp.

Cables
Hi-Lex Corp.

Cargo Beds
Toyota Auto Body Inc. of California

Electronic Parts (Miscellaneous)
Hitachi Automotive Products (USA) Inc.
Jideco of Bardstown, Inc.
I.I. Stanley Co., Inc.

Engine and Transmission Parts (Die-Cast)
Cast Forge Co.
Sheller-Ryobi Corp.

Engines
Honda of America Manufacturing, Inc.

Exhaust Systems
Bellemar Parts Industries Inc.
Calsonic Manufacturing Corp.

Glass
AP Technoglass Corp.
Belletech Corp.
Penstone Inc.
United L-N Glass, Inc.

Heaters
Nippondenso Manufacturing U.S.A., Inc.

Instrument Panels and Other Plastic Parts
Greenville Technology Inc.
Kantus Corp.
Neaton Auto Products Manufacturing Inc.
Woodbridge INOAC Inc.

Instruments
New Sabina Industries Inc.
VDO-YAZAKI Corp.

Lettering
Kux Manufacturing Co.

Lighting Equipment
North American Lighting, Inc.
Stanley Electric U.S. Co., Inc.

Mats
AMTEX Inc.
Viam Manufacturing Inc.

Mechanical Components (Miscellaneous)
Aisin U.S.A. Inc.

Motors
Jideco of Bardstown, Inc.

Radiators
Calsonic Manufacturing Corp.
Nippondenso Manufacturing U.S.A., Inc.

Radios
Alpine Electronics Manufacturing of America Inc.
Clarion Manufacturing Corp. of America
Fujitsu Ten America Inc.
Matsushita Communication Corp. of America
Pioneer Industrial Components Inc.

Rubber Products (Miscellaneous)
Tokai Corp.

Seals
NOK Inc.

Seats
Bellemar Parts Industries Inc.
Bloomington Seating Co.
Tri-Con Industries, Ltd.

Sound Control Products
United Globe Nippon, Inc.

Spark Plugs
NGK Spark Plugs (U.S.A.), Inc.

Springs
NHK-Associated Spring Suspension Components Inc.
Service Spring Co.

Stampings
KTH Parts Industries Inc.
Ogihara America Corp.
Tomasco Mulciber Inc.

Steering Wheels
Izumi Corp.
Neaton Auto Products Manufacturing Inc.
TG (U.S.A.) Corp.

Suspension Parts
Musashi U.S.A. Inc.

Telephones
ASTRONET Corp.
Fujitsu America, Inc.
Matsushita Communication Corp. of America
Mitsubishi Consumer Electronics America, Inc.
NEC America, Inc.
Oki America Inc.

Tires
ATR Wire and Cable Co.
Bridgestone (USA) Inc.
Dunlop Tire Corp.

Turbochargers
Warner-Ishi Corp.

Weather Stripping
CKR Industries, Inc.
Nishikawa Standard Co.

Wheels
Bellemar Parts Industries Inc.
Cast Forge Co.
Central Manufacturing Co.
Enkenei America Inc.
Honda of America Manufacturing, Inc.
Topy Corp.

Windshield Washers and Parts
Asmo Manufacturing Inc.
Nippondenso Manufacturing U.S.A., Inc.

Wire Harnesses
PEP Industries Inc.
Sumitomo Electric Wiring Systems Inc.

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JEI

REPORT

NO. 11B
March 20, 1987

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Ways and Means Committee Acts On Trade Bill

The House Ways and Means trade subcommittee approved a milder version of the trade law sections of HR 3 than expected on March 12. The proposal issued by committee chairman Dan Rostenkoski (D, Ill.) and trade subcommittee chairman Sam Gibbons (D, Fla.) was slightly amended before being sent to the full committee, where the markup process is expected to be finished by the end of March. The co-chairmen's proposal, which represents an attempt to develop a compromise between the administration and a tough-minded Congress, will probably be approved by the committee, although there will be much discussion and possible amendments on the U.S. response to countries with "excessive" bilateral trade surpluses.

Rep. Richard Gephardt (D, Mo.), who sponsored last year's controversial provision to mandate a 10 percent annual reduction in the trade surpluses of

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reportedly plans to include Y1.8 trillion ($11.6 billion at Y155=$1.00) for public works spending, which is almost 30 percent of the proposed spending appropriation for FY 1987.

The vice minister of International Trade and Industry, Shinji Fukukawa, called last week for strong measures to hike domestic demand. Assuming the yen remains near its current level, he predicted that Japan's unemployment rate will rise to 4 percent by 1990 from its current record-high 3 percent. Although the stimulus package being drafted by the EPA will not be made public prior to parliamentary approval of the new budget, it is expected to include additional public works spending as well as deregulation aimed at encouraging private-sector output. A further loosening of monetary policy, however, is not likely to be part of the program. Bank of Japan governor Satoshi Sumita said March 11 that the five discount rate cuts since the beginning of 1986 have lowered interest rates sufficiently.

Randall S. Jones

Notes

Congress - The current emphasis on the trade deficit is well illustrated by the sheer number of congressional hearings scheduled on this issue. During the week of March 9-13 alone there were no less than 20 congressional sessions on some aspect of the drive to revitalize this country's role in the global trade arena. The range of topics was broad, including agricultural trade, omnibus trade legislation, tied aid, export controls, the impact of the Latin America debt crisis, and several specific sectors (for example, telecommunications equipment, timber and the merchant marine). The now-familiar theme of competitiveness occurred frequently in those hearings, as it did in sessions devoted to making our educational and labor relations practices more conducive to productivity gains.

International VAN Services - Tokyo agreed March 12 to liberalize the international value-added network market in a further step toward telecommunications deregulation. The agreement is an extension of the U.S.-Japan market-oriented, sector-selective (MOSS) talks held in 1985-86. The Ministry of Posts and Telecommunications hopes to submit legislation in the current session of the Diet to allow private firms to begin offering services including electronic mail, data transmission and processing services as early as this fall. Several U.S. firms, including GTE Telenet Communications Inc. and MCI Communications Corp., already lease international circuits from Kokusai Denshin Denwa Co., Ltd. for voice transmission but are prohibited from offering value-added services. Japanese companies, such as Intec Inc. and NEC Corp., as well as other American firms, including IBM Japan Ltd., are also interested in entering the international VAN market.

FY 1987 Car Quota Allocation - Despite continued grumbling by smaller Japanese motor vehicle manufacturers about how the annual quota on U.S.-bound car shipments is allocated, the Ministry of International Trade and Industry has decided to make only one change in the formula for FY 1987: giving Daihatsu Motor Co., Ltd., the last of Japan's nine car makers to move into the American market, an allotment so that it can begin distribution later this year. The ministry, which has never made public its list of quota allocations, did not announce a shipment number for Daihatsu, but a Japanese automotive trade paper says the producer of mini cars will be allowed to export 11,498 cars to this country during the April 1987-March 1988 period -- 0.5 percent of the unchanged 2,300,000-unit quota for FY 1987 (see JEI Report No. 4B, January 30, 1987). To accommodate these shipments, Nikkan Jidosha Shimbun reported, MITI made a 0.5 percent across-the-board cut in the allocations for other manufacturers.

Unofficial Quota Allocations, FY 1981-FY 1987

(in units)

Exporter	FY 1981-FY 1983 Quota	FY 1984 Quota	FY 1985-FY 1986 Quota	FY 1987 Quota
Toyota Motor Corp.	516,659	551,792	616,900	613,816
Nissan Motor Co., Ltd.	456,030	487,040	544,500	541,778
Honda Motor Co., Ltd.	348,631	372,338	427,000	424,865
Mazda Motor Corp.	159,282	173,468	227,800	226,661
Mitsubishi Motors Corp. (including sales to Chrysler Corp.)	112,584	122,612	195,100	194,125
Isuzu Motors, Ltd. (including sales to General Motors Corp.)	16,800	49,500	120,400	119,798
Fuji Heavy Industries, Ltd.	70,014	76,250	107,600	107,062
Suzuki Motor Co., Ltd. (for sale to General Motors Corp.)	0	17,000	60,700	60,397
Daihatsu Motor Co., Ltd.	0	0	0	11,498
Total*	1,680,000	1,850,000	2,300,000	2,300,000

*Not included in these figures are the separate quotas on exports of four-wheel-drive vehicles, station wagons and mini vans and on shipments to Puerto Rico. These quotas are estimated at 112,900 units and 95,700 units, respectively, for the FY 1985-FY 1987 period.

NEC-Intel Case - NEC Corp. lost its bid in early March to disqualify the judge hearing its copyright dispute with Intel Corp. over microprocessor design. Appeals Court Judge William Schwarzer ruled that ownership of approximately $80 worth of Intel stock by presiding Judge William Ingram was not enough to bias Judge Ingram's decision that the set of instructions built into a microprocessor is copyrightable (see JEI Report No. 36B, October 3, 1986). Judge Schwarzer argued that Judge Ingram's membership in a stock club that owned 60 shares of Intel "was too slight to raise a reasonable question as to his impartiality," and pointed out that Judge Ingram resigned from the club as soon as he learned of the possible conflict. Lawyers for NEC immediately appealed the decision, postponing final hearings in the case. Judge Ingram still must rule on whether NEC copied Intel's code.

* * * * * *

The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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REPORT

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THE ECONOMIC IMPLICATIONS OF JAPAN'S AGING POPULATION

Summary

Japan is the midst of a rapid demographic transition that will make its population one of the oldest in the world by the year 2025. At that point there will be only three working-age persons for every retiree, a sharp drop from the current seven-to-one ratio. The aging of Japan's population will have a major impact on saving rates, labor practices and demands for government social expenditures. According to an International Monetary Fund study, government pension and medical care spending will jump from 9 percent of gross domestic product in 1980 to 21.5 percent in 2025.

Tokyo estimates that under its current pension system, the greying of the population will contribute to an increase in the pension insurance contribution rate from its current 12.4 percent of workers' wages to nearly 30 percent. Such a sharp increase in tax rates, the government fears, would spell an end to Japan's economic dynamism. These projections help explain Japan's reluctance to adopt a stimulative fiscal policy that would increase the nation's public debt at the expense of future generations. Changes in the pension system, such as raising the retirement age and lowering benefits, would limit the rise in pension costs.

The Japanese Welfare State

There exists a common perception that Japan's economic success during the postwar era has come at the expense of an adequate domestic social welfare system. It is generally assumed that Tokyo has instead emphasized policies to enhance its position in international competition. This perception continues to influence studies of Japan's economy; some analysts, for example, still cite the lack of an effective pension system as a factor contributing to Japan's high saving rate.

In fact, Japan's social welfare spending increased at a 15.5 percent average annual pace between FY 1973 and FY 1984, reflecting a conscious decision by the government to improve the quality of life through increased expenditures on welfare, social infrastructure and pollution control. Government social welfare spending rose from 5.2 percent of gross national product in FY 1973 to 11.1 percent in FY 1984 (see Table 1). On a per-capita basis, payments rose fivefold compared to a 2.4 times increase in GNP (see Table 2).

Table 1: Trends In Government Social Welfare Spending In Japan

(percent of gross national product)

Fiscal Year	Medical Care	Pensions	Other*	Total
1970	2.8%	1.1%	0.8%	4.7%
1973	2.9	1.4	0.9	5.2
1975	3.7	2.6	1.4	7.7
1980	4.3	4.3	1.4	10.0
1984	4.4	5.1	1.5	11.1

*Includes unemployment insurance benefits, workers' compensation, and child allowances.

Source: Social Security Research Institute

Table 2: Government Social Welfare Spending and Gross National Product

(in thousands of yen per capita)

	Government Welfare Spending		Gross National Product	
Fiscal Year	Actual Amount	Index	Actual Amount	Index
1970	Y33.7	60.2	Y724.6	67.8
1973	56.0	100.0	1,069.4	100.0
1975	104.3	186.3	1,359.7	127.1
1980	210.2	375.4	2,094.3	195.8
1984	279.3	498.8	2,521.4	235.8

Source: Social Security Research Institute

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The rapid growth in social welfare spending brought Japan closer to international norms, although it remained last among the seven major industrial countries, according to an IMF study. Government social expenditure as a share of Japan's gross domestic product was 17.5 percent in 1981 compared to 20.8 percent in the United States (see Table 3). It should be pointed out, however, that the private sector plays a more important role in this country. According to the IMF, the government accounted for 92 percent of overall social expenditure in Japan in 1980, compared to 68 percent in the United States.

Table 3: Government Social Expenditure in the Major Industrial Countries

(as a percent of gross domestic product)

Country	Pensions 1960	Pensions 1981	Health 1960	Health 1981	Other* 1960	Other* 1981	Total 1960	Total 1981
Canada	2.8%	4.6%	2.4%	5.6%	6.9%	11.3%	12.1%	21.5%
France	5.9	11.9	2.5	6.5	5.0	11.1	13.4	29.5
Germany	9.8	12.5	3.1	6.5	7.6	12.5	20.5	31.5
Italy	5.5	13.2	3.2	6.0	8.1	9.9	16.8	29.1
Japan	1.4	4.8	1.3	4.7	5.3	8.0	8.0	17.5
United Kingdom	4.1	7.4	3.4	5.4	6.4	14.9	13.9	27.7
United States	4.2	7.4	1.3	4.2	5.4	9.2	10.9	20.8

*Primarily education.

Source: International Monetary Fund, Aging and Social Expenditure in the Major Industrial Countries, 1980-2025, (1986), p. 60.

Social Security Programs

Until the early 1970s, Japan's social security system was relatively primitive. Government statistics report that in 1960, 82 percent of the elderly lived with their children. The decline in that ratio to 65 percent in 1984 coincided with the development of public pension programs. Government pensions increased at a 14.1 percent real annual rate between 1960 and 1980. Although the share of pensions in national income in Japan is small compared to other countries, this is more a reflection of the smaller share of the elderly in the population rather than the inadequacy of the system. According to Professor Albert Ando of the University of Pennsylvania, Japan's government pension program "is now in many ways substantially more generous than the United States system."

As of April 1984, Japan's public pension programs covered 58.7 million people and paid benefits to 12.5 million recipients. The two major programs, the Employees Pension Insurance and the National Pension Program, each covered about 26 million workers. These programs were supplemented by various schemes for public-sector employees. In addition, private-sector pension programs have grown rapidly and now number over 1,100 corporate programs providing coverage to about 7.25 million workers. Moreover, many firms make lump-sum payments to their employees on retirement.

The EPI provides pensions for employees in the private sector based on earnings and years in the program. At present benefit levels, a retiree with 32 years of enrollment in the system would receive a pension equivalent to 68 percent of the average wage (excluding bonuses). Actually, the average pension is lower, reflecting the short enrollment periods of most current pensioners (see Table 4). The NPP was intended to provide coverage to those not included in other programs, primarily the self-employed, farmers and employees at small enterprises. These pensions are much more modest than those provided under the EPI. Still, there is little poverty among the elderly in Japan, since few people rely on a single pension as their main source of support. In addition to support from their children, about one-fourth of those over 65 work.

Table 4: Pension and Wage Statistics

(thousands of persons and thousands of yen)

	March 1979	March 1984
Average monthly earnings*	Y164.0	Y213.0
Employees Pension Insurance		
Main pension beneficiaries**	1,640.0	2,710.0
Average monthly pension	Y84.0	Y113.3
as percentage of average earnings	51.2%	53.2%
National Pension Program		
Main pension beneficiaries**	4,426.0	6,305.0
Average monthly pension	Y19.4	Y25.9
as percentage of average earnings	11.8%	12.2%
Non-contributory beneficiaries***	3,558.0	2,351.0
Average monthly pension	Y16.5	Y25.1
as percentage of average earnings	10.1%	11.8%

*Corresponds roughly to contract wages, thus excluding bonuses.
**Excludes those who receive partial pensions.
***Those who were aged 50 or over when the National Pension Program was launched in April 1961.

Source: Organization for Economic Cooperation and Development, Economic Survey of Japan, (August 1985), p. 94.

Due to the low premium rate formerly applied, a large percentage of current social security contributions are being transferred to retirees rather than invested for the worker's future retirement. According to a Bank of Japan study, an employee with 30 years participation in the EPI who retired in March 1985 contributed a total of Y4 million ($25,806 at Y155=$1.00) in premiums. This is only a small fraction of the Y26 million ($167,742) in benefits (in terms of present value) to be paid to the participant and his dependents.

In April 1985 the Pension Reform Act was passed to coordinate benefits under the EPI and the NPP and to shore up the plans' financial stability. All citizens in the future will be covered under the NPP, with the EPI serving as a second-tier entitlement based on earnings. The new law will prevent pension benefits from exceeding 68 percent of the average wage. (Without the reform, it would have eventually risen to 83 percent.) The contribution rate for the EPI, which is borne equally by employer and employee, was raised from 9.1 percent of wages (excluding bonuses) to 11.3 percent for female employees and from 10.6 percent to 12.4 percent for male workers.

In addition, a system of universal medical insurance, which was established in 1961, has provided practically free medical care to the elderly since 1972. About half the cost of the national system is funded by an 8.4 percent tax on wages that is paid by both the employer and the employee. Central and local governments provide about 40 percent of the cost and the remainder is paid by the patient.

Japan's Demographic Transition

Since the 1920s Japan has had the youngest population of any industrial country. According to the 1985 census, 10.3 percent of the country's 121.05 million people were 65 years or over, less than the 11.9 percent in the United States and well below West Germany's 15 percent. But Japan faces a rapid demographic transition in the years ahead as a result of the increase in average life expectancy, which climbed from only 50 years for men and 54 for women in 1947 to the longest in the world in 1985 at 74.8 years for men and 80.5 years for women.

In addition, Japan's birth rate (the number of births per 1,000 persons) fell to 11.9 in 1985, the lowest on record for that country. The drop is attributed to the smaller number of women in their 20s, the prime child-bearing age group, as well as a decline in the fertility rate (the average number of births per woman in her lifetime) from 3.65 in 1950 to 1.8 in 1983. Since this is below the 2.1 rate necessary for a stable population, the Health and Welfare Ministry expects the population to begin declining in the year 2013 after hitting a peak of 136.25 million.

According to projections by the IMF, the proportion of the elderly in Japan's population will double from 9 percent to 18.2 percent between 1980 and 2010, reaching 21.2 percent by the year 2025 (see Table 5). This outlook is more optimistic than most since it assumes that the fertility rate will climb to 2.1. The government's Institute of Population Problems predicts that the number of people aged 65 or over will total 31.89 million by 2020, about 23.5 percent of the country's population.

Table 5: Projected Demographic Changes in the Major Industrial Countries

A. Share of Population Aged 65 and Over

Country	1980	2000	2010	2025
Canada	9.5%	11.4%	12.7%	19.3%
France	14.0	14.0	13.6	15.8
Germany	15.5	17.0	20.7	23.6
Italy	13.5	15.7	16.6	19.0
Japan	9.0	14.9	18.2	21.2
United Kingdom	14.8	15.1	15.8	18.5
United States	11.2	13.0	13.8	19.4
Average	12.5	14.4	15.9	19.5

B. Ratio of Population Aged 65 and Over to Population Aged 15-64

Country	1980	2000	2010	2025
Canada	14.1%	16.7%	18.6%	31.1%
France	22.0	21.7	20.6	24.8
Germany	22.9	25.6	31.9	37.9
Italy	20.9	24.0	25.4	29.8
Japan	13.4	22.1	26.8	34.6
United Kingdom	23.1	23.2	24.0	29.4
United States	16.9	19.6	20.6	31.4
Average	19.1	21.7	24.3	31.2

Source: International Monetary Fund, Aging and Social Expenditure in the Major Industrial Countries, 1980-2025, (1986), p. 60.

While a number of other countries, such as West Germany, are likely to have an even larger share of the elderly, the impact of demographic change will be stronger in Japan because the change will have been more abrupt. The share of Japan's population age 65 and over is expected to double from 7 percent to 14 percent in only 26 years (see Table 6). In contrast, a doubling of this figure is expected to take 70 years in the United States and 130 years in France. The IMF concludes that:

> The impact of the demographic change on the Japanese economy is likely to be the most extreme among the Group of Seven, reflecting both the lateness with which Japan began the demographic transition to a lower fertility rate and a higher life expectancy, and the sharpness of the change that has been experienced.

Table 6: Comparison of Demographic Transition

(percent of population aged 65 or older)

Country	7 percent	14 percent	Doubling time
France	1865	1995	130 years
Sweden	1890	1975	85 years
Australia	1940	2020	80 years
United States	1945	2015	70 years
Italy	1935	1990	55 years
Britain	1930	1975	45 years
West Germany	1930	1975	45 years
Japan	1970	1996	26 years

Source: Ministry of Health and Welfare

The Economic Implications of Demographic Change

Demographic changes have far-reaching economic effects. The growth rate of the population influences the size and structure of the labor force as well as the composition of demand for goods and services. In addition, it affects the demand for social welfare spending by the government. Some analysts expect the aging of Japan to spell the end of its postwar economic dynamism, which has relied primarily on human resources. Others see an end to Japan's social cohesiveness, as young workers struggle to support the large number of elderly.

The greying of the labor force and its decline in absolute size after the year 2000 may result in a decline in economic efficiency that lowers Japan's growth potential and forces a change in labor practices. It is likely to make the seniority system, under which wages increase in proportion to length of service with a company, too expensive. Moreover, there will be fewer promotion opportunities, further damaging worker morale. The effect of aging on productivity is ambiguous; many argue that the loss of a young and vigorous labor force that is adaptable to new technology will outweigh the benefits of a more experienced work force.

It is clear that the aging of Japan's population will lead to an increase in social welfare expenditure, despite a decline in education expenses resulting from the fewer number of children. The IMF estimates that even if per-capita welfare benefits remain constant in real terms, demographic changes alone will raise government social expenditures 361 percent, or about 4 percentage points of national income over the next 40 years. Moreover, this projection is an optimistic one, since per-capita benefit levels, particularly pensions, are likely to rise faster than inflation. As pensioners' average length of enrollment in the system increases, the average monthly pension will approach its long-run level of 68 percent of current wages.

Table 7: Government Social Expenditures in the Major Industrial Countries

(as percent of gross domestic product)

Country	1980	2000	2010	2025
Japan				
Medical care	4.80%	6.05%	7.08%	8.06%
Pensions	4.20	9.61	12.89	13.40
Education	5.10	4.10	4.60	4.40
Other	1.30	1.30	1.30	1.30
Total	15.40	21.06	25.86	27.16
Canada	20.29	17.35	17.40	20.69
France	31.00	32.44	32.61	35.07
Germany	31.08	33.15	35.30	38.77
Italy	25.06	27.67	30.21	34.66
United Kingdom	22.90	22.94	23.96	26.52
United States	17.67	16.44	16.57	19.44

Source: International Monetary Fund, Aging and Social Expenditure in the Major Industrial Countries, 1980-2025, (1986), p. 56-57.

As Japan's social security system matures, the IMF predicts that pension expenditures will rise from 1980's 4.2 percent of gross domestic product to 13.4 percent in 2025 (see Table 7), much higher than the 6.9 percent projected for the United States. The rise will force a substantial hike in the tax burden of employees and employers. The Ministry of Health and Welfare expects the contribution rate to rise to 28.9 percent by the year 2020 (see Table 8).

Table 8: Pension Cost Projections For Employees' Pension Insurance

(in trillion yen)

	Contribution Rate* (percent)				Ratio of Reserves to Annual
Year	Male	Female	Surplus	Reserves	Expenditure
1986	12.4%	11.3%	Y5.3	Y61.6	5.7
1990	12.4	12.1	5.4	83.2	5.4
1995	14.2	14.2	5.3	111.5	4.4
2000	16.0	16.0	3.4	133.8	3.5
2005	18.7	18.7	0.0	138.6	2.5
2010	23.4	23.4	0.0	138.6	1.7
2020	28.9	28.9	n.a.	n.a.	n.a.

*As percent of basic wages excluding bonuses. Contributions are shared equally by employer and employee.

Source: Ministry of Health and Welfare

Demographic factors are also important in determining medical expenditures, since the frequency and severity of illness increase progressively after age 65. The 9 percent of the population over 65 years old in Japan accounted for 27.4 percent of government medical expenditures in 1980, and that ratio is expected to rise to almost 50 percent in the next 40 years. Demographic factors alone, the IMF estimates, will raise government expenditures in this area by 47 percent in real terms between 1980 and 2025. The increase in government medical expenditures to over 8 percent of GDP in 2025 will force further increases in the contribution rate for medical insurance.

According to the Ministry of Finance, the overall tax burden in Japan will reach a postwar high of 36.1 percent of gross domestic product in FY 1986. Contributions for the government pension and medical insurance programs accounted for 11 percentage points of the total. In the absence of major reforms, this percentage will rise sharply, raising the total tax burden to as high as 50 percent of GDP during the next 40 years. The rise in taxes to such levels in some European countries is responsible for a variety of economic problems that could also develop in Japan.

First, it is likely to lower the saving rate. Assuming the pension eligibility age is raised to 65 years, the 1985 economic white paper projected that the household saving rate would fall from its current level of about 20 percent to between 10 percent and 13 percent in the next 40 years. While this may be considered a plus, given Japan's excess supply of domestic saving and its resulting current account surplus, it could eventually lead to a shortage of investment funds. In addition, higher taxes on the business sector, which must match workers' social insurance payments, will discourage employment gains and reduce corporations ability to invest, slowing labor productivity gains. (The higher cost of employing workers, though, will encourage business to invest in labor-saving machinery). And finally, higher marginal tax rates will weaken labor's incentive to work.

Demographic Transition and the Fiscal Policy Debate

Japan is under pressure at home and abroad to stimulate its economy. At last February's Group of Seven meeting, Japan agreed to adopt policies to boost domestic demand (see JEI Report No. 8B, February 27, 1987). Monetary policy has already been used extensively -- the central bank has cut the discount rate five times since January 1986 -- resulting in record-low interest rates. The emphasis, therefore, must be on fiscal policy.

The scope for fiscal expansion, though, is limited by the ruling Liberal Democratic Party's goal to end the practice of issuing deficit-covering bonds by FY 1990. This commitment reflects concern over the growth of public debt following the rise in government spending in the 1970s. Fiscal austerity has reduced deficit bonds, which covered 27 percent of central government expenditures in FY 1979, to 9 percent in FY 1987 (see Table 9). Debt service costs, however, have continued to increase to 20.9 percent of total spending (compared to 13.5 percent in the United States).

Table 9: Public Bond Issues, FY 1976-FY 1987

(in billions of yen, initial budget)

	Bond Issues		Dependence**		Outstanding Debt		Debt Service	
FY	Total*	Deficit Financing	Total	Deficit Financing	Total	Percent of GNP	Total	Percent of Spending
1976	Y7,275	Y3,750	29.9%	19.3%	Y22,076.7	12.9%	Y1,664.7	6.9%
1977	8,480	4,050	29.7	17.8	31,902.4	16.8	2,348.7	8.2
1978	10,985	4,935	32.0	18.4	42,615.8	20.4	3,222.7	9.4
1979	15,270	8,055	39.6	27.1	56,251.3	25.0	4,078.4	10.6
1980	14,270	7,485	33.5	22.0	70,509.8	28.8	5,310.4	12.5
1981	12,270	5,485	26.2	14.4	82,273.4	31.7	6,654.2	14.2
1982	10,440	3,924	21.0	9.5	86,482.2	35.4	7,829.9	15.8
1983	13,345	6,980	26.5	16.6	109,694.7	38.6	8,192.5	16.3
1984	12,680	6,455	25.0	15.2	121,693.6	40.1	9,155.1	18.1
1985	11,680	5,730	22.2	12.8	134,431.4	41.9	10,224.1	19.5
1986	10,946	5,246	20.2	11.3	143,200.0	42.5	11,319.5	20.9
1987	10,501	4,981	19.4	9.2	n.a.	n.a.	11,333.5	20.9

*Includes both construction and deficit-financing bonds.
**As percent of total revenues.

Source: Ministry of Finance, Financial Statistics of Japan, 1986.

Some influential party leaders, however, have recently urged Prime Minister Yasuhiro Nakasone to postpone or withdraw the fiscal 1990 target and focus instead on boosting economic growth. Although the government outlook calls for 3.5 percent real growth in FY 1987, some economists predict it will fall under 2 percent. Mr. Nakasone's reluctance to abandon the policy of fiscal restraint is more understandable in light of the long-term implications of an aging society. Although Tokyo will probably take steps to prevent the burden of pension insurance programs from reaching the projected 29 percent of wage income, supporting the elderly will pose a serious problem for the economy. The government believes it is important, therefore, to continue to restrain the issue of government bonds in order to avoid increasing the burden on future generations. Moreover, fiscal policies that permit a decline in the cost of financing the public debt from its FY 1986 level of 3.4 percent of GNP will make Japan's demographic transition less difficult.

Policy Options

The Japanese government is considering reforms to keep the cost of social insurance programs manageable while still meeting its obligations to the sick and elderly. Small policy changes in the 1980s will have a profound impact on the cost of such programs 40 years from now. In addition, long-term policies, such as efforts to stabilize the size of the population through increasing the birth rate or encouraging immigration, could also have important effects.

The obvious policy response to an excessive rise in the cost of social security is to reduce pension benefits, raise the retirement age or some combination of the two. The 1985 Pension Reform Act limits the rise in pension benefits and keeps the contribution rate at 28.9 percent in 2025, well below the 38.8 percent projected under the old system. Additional reductions in future pension benefits would further moderate the increase in the contribution rate. Although this would lower transfers to future retirees, tomorrow's elderly will have earned more income throughout their lives than earlier generations and thus will accumulate more resources for retirement. A recent survey by the Bank of Japan found that people over 60 years of age own more financial assets than any other age group.

Although 60 is the standard eligibility age for pensions in Japan, Tokyo is considering raising it to 65 to encourage workers to remain in the labor force longer, thereby reducing pension costs. The 1985 economic white paper estimated that this would lower contribution rates by 5 percentage points to 23.8 percent in 2025. With the exception of the United States, no other OECD country contemplates raising the pension age for fear of exacerbating already serious unemployment problems. This may become an issue in Japan, which anticipates a rise in its unemployment rate, currently at a record high 3 percent. (Many analysts estimate this rate would be twice as high if it were calculated using the U.S. definition of unemployment.)

Japan's relatively young retirement age, generally set at 55, has made it difficult to raise the initial age for pension benefits to 65. The government has had some success in this area, though. A 1986 survey reported that over 50 percent of corporate employers have adopted a retirement age of 60 years or older. Despite this change, the labor force participation rate for men aged 55-64 years continued to decline from 85.4 percent in 1980 to 83.8 percent in 1984. Public pension programs that encourage workers to remain in the labor force until at least 65 will help limit the rise in pension costs.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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REPORT

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Japan's FY 1986 Growth Outlook Appears Out Of Reach

Despite a plunge in consumer spending, Japan's inflation-adjusted gross national product increased at a 3.2 percent annual rate in the October-December 1986 quarter, up from a revised 3 percent in the July-September period (see Table 1). The fourth-quarter figure raised real growth for calendar 1986 to 2.5 percent, still the lowest level registered since 1974 in the wake of the first oil shock. Even so, Japan's economic performance last year matched that of the United States and the European Community (see Table 2).

Table 1: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	1985	1986	January-March 1986	April-June 1986	July-September 1986	October-December 1986
Gross National Product	Y291,207.1 (4.7%)	Y298,346.6 (2.5%)	Y294,483.4 (-1.7%)	Y297,230.1 (3.8%)	Y299,438.0 (3.0%)	Y301,772.9 (3.2%)
Personal Consumption Spending	162,103.3 (2.6%)	166,478.9 (2.7%)	164,123.7 (1.6%)	166,134.2 (5.0%)	168,282.2 (5.3%)	167,131.1 (-2.7%)
Private Residential Construction	14,002.1 (2.6%)	15,418.1 (10.1%)	14,340.6 (6.3%)	14,808.5 (13.7%)	15,851.9 (31.3%)	16,627.0 (21.0%)
Private Fixed Nonresidential Investment	52,224.6 (12.3%)	55,578.4 (6.4%)	54,983.4 (1.3%)	55,204.3 (1.6%)	55,471.9 (2.0%)	56,562.6 (8.1%)
Change in Business Inventories	2,273.1 (62.1%)	1,136.5 (-50.0%)	1,726.5 (-60.1%)	639.5 (-98.1%)	920.4 (329.1%)	1,256.9 (247.8%)
Government Current Expenditures	27,072.9 (2.0%)	28,868.3 (6.6%)	27,606.7 (3.5%)	27,719.2 (1.6%)	28,058.0 (5.0%)	32,106.4 (71.5%)
Government Fixed Investment	20,935.6 (-6.6%)	21,858.9 (4.4%)	21,022.4 (1.2%)	21,785.4 (15.3%)	22,180.2 (7.4%)	22,363.0 (3.3%)
Change in Government Inventories	302.2 (*)	808.5 (*)	39.6 (*)	3,251.8 (*)	1,795.1 (*)	-1,850.1 (*)
Net External Sector	12,293.1 (29.8%)	8,198.9 (-33.3%)	10,640.6 (-42.8%)	7,687.2 (-72.8%)	6,878.0 (-35.9%)	7,576.0 (47.2%)
Exports of Goods and Services and Factor Income Received	55,133.4 (5.3%)	52,471.5 (-4.8%)	52,208.9 (-12.4%)	53,044.1 (6.6%)	52,640.0 (-3.0%)	51,998.3 (-4.8%)
Imports of Goods and Services and Factor Income Paid	42,840.3 (-0.1%)	44,272.6 (3.3%)	41,568.3 (-1.6%)	45,356.9 (41.8%)	45,762.0 (3.6%)	44,422.3 (-11.2%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

Table 2: Real Economic Growth Rates in Selected Countries

Year	United States	Japan	West Germany	Great Britain	European Community	Republic of Korea
1982	-2.5%	3.1%	-1.0%	0.8%	0.5%	5.4%
1983	3.6	3.2	1.8	3.8	1.4	11.9
1984	6.4	5.1	3.0	1.8	2.3	8.4
1985	2.7	4.7	2.5	3.8	2.4	5.4
1986	2.5	2.5	2.4	2.6	2.5*	12.2*
1987**	3.2	3.5	2.5	3.0	2.3	8.0

*Estimated.
**Government forecasts. The 3.5 percent figure for Japan is Tokyo's outlook for FY 1987.

Source: Nihon Keizai Shimbun, March 14, 1987

External demand was a drag on the economy for the first time in seven years. Without the decline in net exports, real growth would have reached 3.9 percent. A 10.1 percent jump in housing investment, though, boosted the economy. Encouraged by low interest rates and government incentives, housing starts in 1986 topped 1.36 million, the highest since 1979. Business investment, though slowed by the drop in manufacturing firms' profits, also remained strong.

Growth in the fourth quarter was slowed by a 2.7 percent contraction in consumer spending, the first decline in 12 years, which officials blamed on the small bonuses paid in December. Although exports declined for the second consecutive quarter, imports dropped even more. As a result, external demand accounted for 0.2 percentage point of the 0.8 percent quarterly rise in GNP.

The results for the October-December quarter make it unlikely that the economy will attain the government's revised 3 percent real growth outlook for fiscal year 1986 (April 1, 1986-March 31, 1987). That would require the economy to expand at a 10.8 percent annual rate during the first three months of 1987.

The latest economic statistics brought renewed calls for government policies to boost the economy. Noboru Gotoh, president of the Japan Chamber of Commerce and Industry, urged the prime minister last week to increase public works spending. The Liberal Democratic Party and four opposition parties did agree on a Y7.9 trillion ($52.7 billion at Y150=$1.00) provisional budget, including Y1.8 trillion ($12 billion) on public works, to cover the first 50 days of FY 1987, beginning April 1. The stopgap measure is necessary because the opposition parties' stiff resistance to the proposed 5 percent value-added tax has delayed passage of next year's budget.

Tokyo continues to work on an economic stimulus package to help achieve 3.5 percent real growth in fiscal 1987. Economic Planning Agency director

Tetsuo Kondo said the program will be announced before the annual economic summit scheduled for June 8-10 in Venice. Mr. Kondo also urged prosperous industries to grant significant wage increases to workers in order to boost consumer spending. Most analysts expect this year's wage hikes to average less than 4 percent, down from last year's 4.5 percent.

Randall S. Jones

Effect Of The Yen's Appreciation On Japanese Export Prices

Although Japan's trade surplus jumped to a record $82.7 billion in 1986, the appreciation of the yen since February 1985 has started to shift trade flows in the expected direction. Export volume fell last year, the first decline since the 1982 recession.

The decline in export volume has been tempered by the fact that the prices of many goods do not fully reflect the currency changes that have taken place. At least for the short run, many producers have chosen to cut costs and sacrifice profits rather than risk losing market share by raising prices the full amount of the yen's appreciation. These cost-cutting efforts have been aided by less expensive industrial inputs, particularly oil, while record or near-record corporate profits in 1984 and 1985 left firms in good shape to fight for market share.

As the table shows, exporters passed on only 54.6 percent of the yen's 47.1 percent rise against the dollar in the form of price increases in the 15 months from September 1985, substantially less than the two-thirds hike in the February-November 1978 period when the yen appreciated 30.6 percent. One reason for this is that with relatively low inflation, price increases are more likely to reduce market share. Inflation in the United States was only 1.9 percent last year (3.9 percent excluding energy), compared to 7.7 percent in 1978.

Of the 12 industries for which data are available in both periods, 10 passed on a smaller percentage of the yen's appreciation in 1985-86 than in 1978. Many of these industries face increased competition, particularly from the newly industrialized countries of Asia. Steelmakers in 1978, for example passed on 80.2 percent of the yen's appreciation. For 1985-86, in contrast, that figure was only 7.7 percent.

The considerable variation by industry also reflects the nature of the good produced. The amount of the yen's appreciation passed on by exporters of basic industrial intermediates, such as steel and nonferrous metals, is especially low. In some finished products, the reputation of well-known Japanese brand names has permitted larger price increases. Producers of cameras, copiers and video cassette recorders have been able to pass on a relatively high percentage of the yen's appreciation.

Randall S. Jones

Percent of Yen's Appreciation Passed on in Export Prices*

Industry	February-November 1978	September 1985-December 1986
Clothing	79.6%	45.7%
Organic chemicals	25.5	18.2
Inorganic chemicals	n.a.	18.8
Steel	80.2	7.7
Nonferrous metals	71.2	16.7
Metal products	83.1	74.4
Nonelectric machinery	59.2	57.4
Data processing equipment	n.a.	42.6
Electric machinery	74.5	68.7
Color television sets	57.3	65.1
Radio receivers	69.3	45.7
Other telecommunications equipment	n.a.	45.0
Semiconductors	n.a.	38.3
Integrated circuits	n.a.	71.2
Motor vehicles	89.3	63.2
Motorcycles	83.8	78.4
Cameras	67.0	85.5
Copiers	n.a.	73.0
Video cassette recorders	n.a.	71.1
Total Exports	66.3	54.6

*The yen appreciated 30.6 percent against the dollar during the February-November 1978 period and 47.1 percent between September 1985 and December 1986 based on the conversion rates used for customs clearance.

Source: Calculated from Japan Tariff Association, The Summary Report: Trade of Japan

OECD Nations Agree to Limit Mixed Export Credits

The Reagan administration has declared victory in its uphill battle to persuade other industrial nations to stop offering export financing packages that blend foreign aid with normal export credits to win commercial contracts in developing countries. On March 17 the Organization for Economic Cooperation and Development announced that the 22 participants in its "gentleman's agreement" on government-backed export credits had reached an accord to tighten the rules governing mixed or tied-aid export credits. By hiking the cost of using foreign aid funds to promote exports, the changes are expected to control what the White House considers an unfair international trade practice without reducing the flow of true development assistance to the poorest Third World countries.

The Reagan administration has been fighting the use of mixed export credits for commercial purposes by France and other governments almost since the day it took office, claiming that this type of financing unfairly costs American exporters of capital goods overseas sales. After winning agreement

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THE PROBLEM OF U.S. COMPETITIVENESS IN MANUFACTURING: A STUDY BY PAUL R. KRUGMAN AND GEORGE N. HATSOPOULOS*

Summary

Improving the competitive position of American industry is the latest White House prescription for reversing this country's huge trade deficit. This analysis is not universally accepted by either the economics profession or the business community. Even some of the economists and businessmen who applaud the new emphasis question whether the Reagan administration really understands the nature of the problem. Among this group are Paul R. Krugman, professor of economics at the Massachusetts Institute of Technology, and George N. Hatsopoulos, chairman and president of Thermo Electron Corp. and deputy chairman of the board of directors of the Federal Reserve Bank of Boston. Arguing that a turnaround in the trade deficit is inevitable no matter what happens to U.S. competitiveness, they make the case that policymakers, economists and businessmen alike should be focusing on how to facilitate the enormous and costly adjustment that this change will impose on the economy.

Introduction

The debate over the competitiveness of U.S. manufacturing has become increasingly sterile. On one side are business people who look at the declining market shares, poor productivity performance and inferior product quality of

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*Reprinted from Federal Reserve Bank of Boston, New England Economic Review, January-February 1987.

U.S. manufacturing output in the United States and conclude that the United States may cease to be a manufacturing nation. On the other side are professional economists who look at the relatively rapid growth of manufacturing output in the United States and conclude that there is no evidence of a problem. These two views of the world are so different that each side questions the other's intelligence and judgment.

In fact, both sides are right and both sides are wrong. The business people are right in asserting that something is amiss with the competitive performance of U.S. manufacturing, but wrong in believing that this can lead to a collapse of our manufacturing sector. The economists are right in arguing that deindustrialization is not an issue, but wrong in dismissing worries over U.S. manufacturing performance.

The U.S. manufacturing sector is not about to disappear because it cannot. Some time well before the end of the century the United States will be forced to pay its way in the world community. By then we will have to produce enough to cover our own domestic consumption as well as pay interest on our rapidly accumulating foreign debt. This means that the current trade deficit will have to turn into a surplus. While trade includes services and commodities as well as manufactures, only manufactures have a realistic chance to produce the required massive swing in trade. The United States, therefore, will remain a manufacturing nation even if there is no improvement in the productivity and quality of its manufacturing. The forcing mechanism will be a dramatic devaluation of the dollar.

Manufacturing in the United States has indeed performed poorly relative to foreign competition. Its productivity growth has lagged, its technological edge has eroded, and its product quality has not kept pace with that of foreign manufacturers. Such poor performance will not prevent the United States from selling its manufactured products if the price is right. It will, however, lower the right price. In order to sell its manufactured goods on world markets, the United States may have to lower their price so much that worsened terms of trade will cut deeply into the U.S. standard of living. The right question, therefore, is: at what price will the mandatory reversal of the trade deficit be accomplished?

Growth of U.S. Manufacturing in the Past

Table 1 presents some key statistics on the growth of U.S. manufacturing since 1969. Peak years in the business cycle are shown to minimize cyclical effects.

The first line in the table shows manufacturing output as a percent of gross domestic product. This share has steadily declined. Until 1980, however, the decline was almost entirely due to a decline in domestic demand rather than foreign competition. As the second line shows, U.S. trade in manufacturing during the 1970s was roughly balanced, and thus the share of manufactures in U.S. production was almost exactly the same as their share in U.S. demand.

It is also notable that the declining share of manufactures in demand did not reflect a declining preference by consumers for manufactured goods.

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The third line of the table shows the share of manufactured goods in output in constant dollars. This share was stable during the 1970s, indicating that the volume demand for manufactures grew as rapidly as overall demand. The declining share of manufactures in nominal GDP was thus entirely due to a lower rate of inflation in manufacturing than elsewhere resulting from the faster productivity growth in the manufacturing sector.

Table 1

Indicators of U.S. Manufacturing Performance

Percent of GDP

	Business Cycle Peak Years			
	1969	1973	1979	1985[a]
Manufacturing Output (Current Dollars)	26.9	24.3	22.8	20.1
Manufacturing Trade Balance	0.2	0.0	0.2	-2.6
Manufacturing Output (Constant 1982 Dollars)	22.3	22.9	22.2	21.9

[a] Most recent year for which data available The expansion that began in 1983 continued into 1986

Source *Survey of Current Business*

After 1980, U.S. manufacturing trade plunged sharply into deficit. Surprisingly, the constant-dollar manufacturing share has not fallen much, reflecting an apparent shift in domestic volume demand toward manufactures. However, the growing trade deficit has created the impression that U.S. industry has suddenly lost its ability to compete. Such an impression is incorrect. First, we shall show that U.S. competitiveness has not declined suddenly but has been declining gradually over a long period of time. We shall also show that it is inevitable that U.S. manufacturing will grow sufficiently fast to reverse the current trade deficit and turn it into a surplus.

U.S. Competitiveness in Manufacturing

The most obvious indicator of U.S. competitiveness in manufacturing is the raw trade balance. This indicator by itself, however, can be misleading. A decline in demand for manufactures abroad can lead to a trade deficit by reducing U.S. exports, even if U.S. firms remain competitive. This possibility is the basis of an influential but misleading view that the failure of the rest of the world to expand their economies is the principal cause of the U.S. trade deficit. Conversely, as we shall see, balanced trade may obscure deeper problems.

Another indicator used in many studies is the U.S. share of manufactured exports of industrial countries. We regard this measure as inadequate, however, for at least two reasons. First, it neglects the import side. As the U.S. trade deficit grew larger, the surge in the share of imported manufactures was even more striking than the decline in U.S. exports -- one of the reasons why insufficient foreign demand cannot be the principal cause of the trade deficit. Second, asymmetries in the pattern of world trade can bias the result. A slump in Western Europe would affect the exports of European Community countries more than those of the United States and thus would raise the U.S. share of world exports; we could not regard this as a gain in competitiveness.

A third alternative might be to measure the U.S. share of world production of manufactures. This share has actually risen in the 1980s. Unfortunately, this measure is also flawed. World markets are far from perfectly integrated. Since demand in the United States has risen more rapidly than demand in the rest of the world, demand for U.S. manufactures has also tended to rise more quickly than demand for foreign manufactures, even though U.S. firms have done less well in each market than their foreign competitors. This explains the peculiar fact that from 1980 to the present, U.S. manufacturing output has risen more rapidly than output of other nations even though U.S. firms have been losing shares in every market.

The Market Share Index - We dealt with the difficulties mentioned above as follows: First, we calculated separately the U.S. share of total real sales of manufactures in the United States and in the rest of the world. Then we defined, as our market share index, the ratio of actual U.S. sales to what those sales would have been if the U.S. share in each market had remained the same as it was in a base year.

Chart 1 shows how this index for base year 1980 has behaved since 1970. During the 1970s the U.S. market share index was relatively stable. Imports were an increasing share of U.S. consumption, but the U.S. share of foreign markets was rising at a comparable rate as world markets became increasingly integrated. Since 1980 the index has clearly taken a downward trend. This decline results from a sharp increase in the import share in the United States, and a less dramatic but still noticeable decline in the U.S. share of foreign markets.

Despite the decline in the market share index, U.S. manufacturing production actually rose much more rapidly than that of the rest of the world after 1980. The reason was that the U.S. market, in which U.S. firms have a large share, grew much faster than the market abroad, where the U.S. share is small.

The size of the decline in our market share index -- about 8 percent -- may seem rather small. It says that if U.S. manufacturing had been able to maintain its 1980 market shares, U.S. manufacturing output in 1985 would have been 8 percent larger than in fact it was. However, for an economy like that of the United States, which is still not highly dependent on trade, a decline in the market share index of this size does, in fact, represent a significant shift. We will show that restoring the U.S. market share, and moving it up to levels that allow us to balance our current account, will be a substantial burden on the U.S. economy.

The Long-Term Decline of U.S. Competitiveness - The decline in our market share index for the United States since 1980 coincides with the rise in the dollar, and a natural reaction is to attribute one entirely to the other. Thus, one might be tempted to argue that there is nothing fundamentally wrong with U.S. competitiveness and that all that is necessary is to get the dollar back down.

We do not accept this view. While the strong dollar played a key role in the abrupt deterioration of the U.S. market share, the stability of that market share index during the 1970s is misleading. The dollar declined a great deal from the beginning to the end of that decade as exemplified by the behavior of the yen-to-dollar exchange rate shown in chart 2. It is possible, and we believe likely, that the United States was able to maintain a stable market share only by making its labor and goods progressively cheaper relative to those of other nations.

The strongest evidence for this view comes when we compare the United States with its most dynamic competitor, Japan. First, chart 3 shows an identically constructed market share index for Japan. Not surprisingly, this index shows a huge upward trend throughout the period, as Japan's share of world markets rose.

Now, we might have expected that in order to gain market share so dramatically, Japan would have had to cut its prices and, therefore, raise wages by less than its productivity growth. In fact, the opposite was true. Chart 4 compares unit labor costs in the United States and Japan. Over the 1970s, Japan was able to increase its market share sharply while that of the United States was flat, even though unit labor costs in Japan were rising relative to those in the United States. This bilateral comparison is also borne out by multilateral indexes; for example, from 1970 to 1980 the International Monetary Fund's measure of U.S. relative unit labor costs fell by 38 percent.

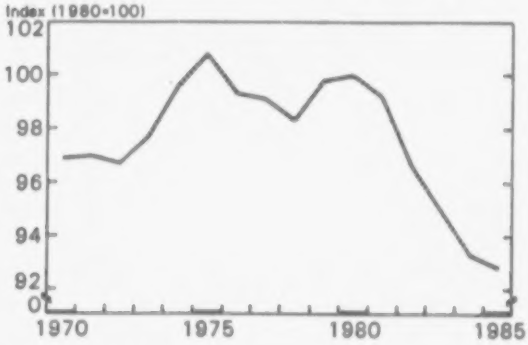
The U.S. manufacturing sector, then, seems to have been able to hold onto its market share only in an environment of steadily declining unit labor costs relative to its competitors. Since, at the same time, U.S. productivity growth lagged far behind that of other countries, U.S. real wages during the 1970s had to rise much less rapidly than those elsewhere. Chart 5 shows once again the comparison with Japan: U.S. productivity growth has lagged far behind Japan's, and probably by now it has fallen behind in absolute terms. What is equally striking, however, is that during the 1970s real wages in the United States lagged even more than U.S. productivity (chart 6).

Why did U.S. firms need a progressive cheapening of their relative labor costs in order to hold onto their markets? Here is where the perceptions of the business community become crucial. Observer after observer has noted a declining U.S. lead in technology and a growing notoriety for inferior product quality. Furthermore, there is evidence that the productivity lag of the United States was most pronounced precisely in the sectors where international competition is most intense. Thus, U.S. firms could hold their own only by competing on the basis of increasingly cheap labor relative to other industrial countries. The root causes of this poor performance are many. It would be hard, however, to expect U.S. manufacturers to do better than they did, given the staggering difference in investment per employee between the United States and Japan, shown in chart 7.

From 1980 to 1985 the historic decline in U.S. relative unit labor costs was temporarily reversed by the rise in the dollar. This rise, of course, led to a fall in market shares, which in turn was the principal cause of the massive U.S. trade deficit. The subsequent decline of the dollar has brought unit labor costs roughly back to their 1970s level against Japan and Europe. However, if the underlying ability of U.S. firms to sell their products has continued to decline -- and there is every reason to believe that it has -- restoring the old position will not be enough. The dollar will have to fall enough to bring U.S. relative labor costs to levels substantially below those of the 1970s just to restore its market share to the 1980 level, while, in order to balance its current account, the United States will have to achieve market shares well above those of the recent past.

Chart 1

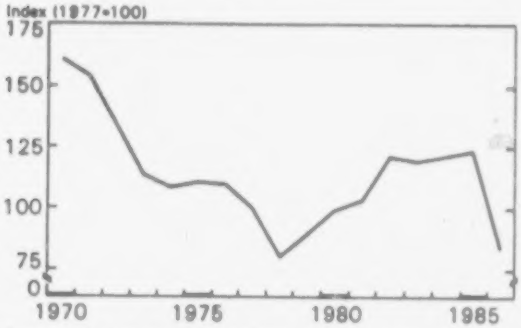
Market Share Index for U.S. Manufacturing



Source: Authors' calculations.

Chart 2

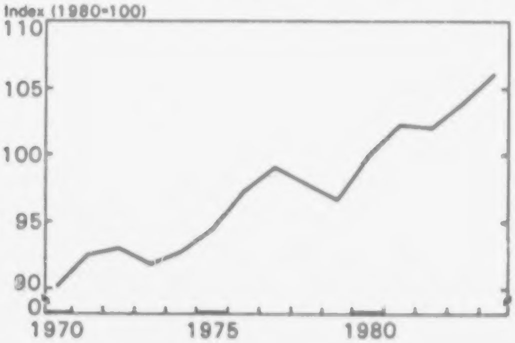
Yen per Dollar Exchange Rate



Source: U.S. Bureau of Labor Statistics, *International Comparisons of Manufacturing Productivity and Labor Cost Trends, 1985.* Values for 1986 estimated by authors.

Chart 3

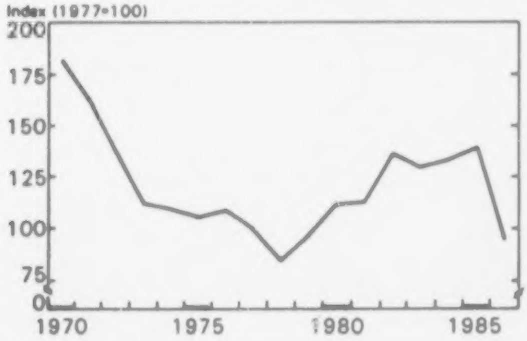
Market Share Index for Japanese Manufacturing



Source: Authors' calculations.

Chart 4

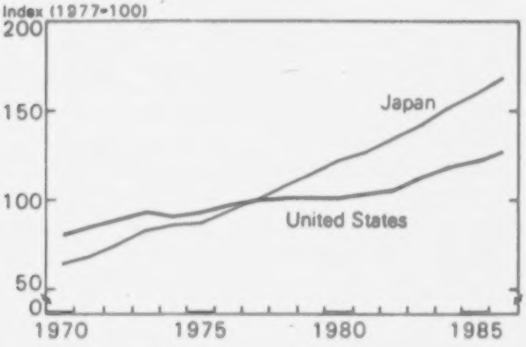
Unit Labor Cost Ratio: United States to Japan



Source: See Chart 2.

Chart 5

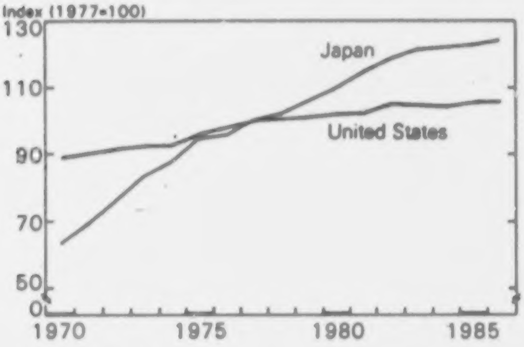
Productivity in Manufacturing



Source: See Chart 2.

Chart 6

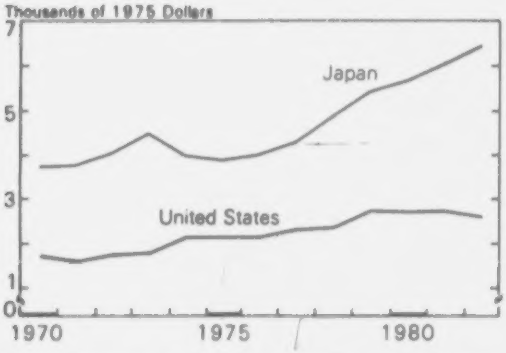
Real Compensation per Hour in Manufacturing



Source: See Chart 2.

Chart 7

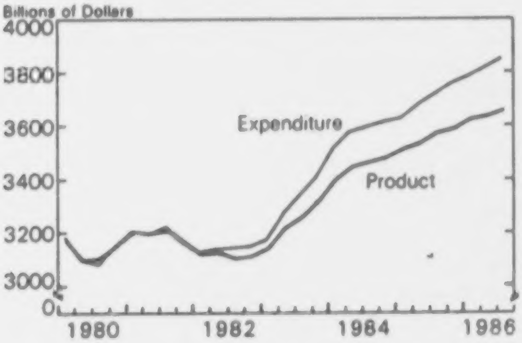
Manufacturing Annual Fixed Investment per Employee



Source: Organization for Economic Cooperation and Development.

Chart 8

U.S. Gross Domestic Product and Gross Domestic Expenditure



Source: U.S. Bureau of Economic Analysis.

Prospects for Future Growth in U.S. Manufacturing

The prospect of an ever-worsening deficit in manufacturing is fundamentally impossible, the key reason being that the worsening of the balance since 1980 has not been offset by an improved U.S. balance in any other sector. Table 2 shows that the decline in the U.S. manufacturing trade balance and the decline in the overall balance on current account were approximately equal. Thus, the United States compensated for its manufacturing trade deficit, not by selling more of something else, but by running down its overseas investments and by borrowing from foreigners. This can go on for a few years, but not indefinitely. The United States has already shifted from being the world's largest creditor to being its largest debtor. Given the size of the U.S. economy, the U.S. debt is not yet a problem; but if the trade deficit were to remain at its present level relative to GNP, within a decade the ratio of debt to GNP would be as high as that of Brazil and a major concern. This is not a feasible outcome, however. Sooner or later a reluctance of foreigners to continue to rapidly increase their holdings of U.S. debt instruments will force a decline in the dollar large enough to enable U.S. firms to sell on world markets. Indeed, this has already begun to happen.

Table 2

Balance on Current Account and Components

Percent of GDP

	Business Cycle Peak Years			
	1969	1973	1979	1985[a]
Balance on Current Account	.04	.53	−.04	−2.97
Merchandise Trade:				
Manufacturing	.18	.02	.17	−2.61
Nonmanufacturing	−.12	.05	−1.29	−.53
Services:				
Factor Income	.63	.90	1.26	.64
Travel and Transportation	−.18	−.24	−.12	−.28
Royalties and Fees	.19	.21	.22	.13
Finance, Insurance, and Professional Services	—	.03	.02	.14
Unilateral Transfers	−.66	−.44	−.30	−.45

[a] Most recent year for which data available. The expansion that began in 1983 continued into 1986.

Source: *Survey of Current Business.*

In principle, the United States could balance its international accounts even while experiencing growing trade deficits in manufacturing if it were able simultaneously to sharply increase its other exports, such as services. Some would argue that this would be a bad thing -- that an economy dependent on service exports is less viable than one based on exports of manufactures. This argument is moot, however, since there is no reason to believe that service exports will play any significant role in closing the U.S. current account deficit.

Trade in services may be divided into two categories. The first and largest is income earned on overseas investments. The United States has traditionally run a substantial surplus in this category, but this surplus has declined sharply and will soon become a deficit as the United States goes deeper into foreign debt. The second category includes travel and transportation services such as tourism, royalties and fees, and professional services such as finance, insurance, consulting, and data processing. It is this category we have in mind when we talk of a service-exporting economy. The components of this category are shown in table 2. In 1985 they totaled less than 1 percent of the balance in manufacturing. Each is very small and none shows a discernible trend.

The fact is that despite substantial media attention, trade in services -- real services, not earnings on past overseas investments -- is a minor aspect of world trade. There is simply no prospect that an economy as large as that of the United States could offset a large manufacturing trade deficit with service exports. So the United States cannot run ever deeper into manufacturing deficit. It will be forced to balance its current account by improving its trade balance in merchandise. While some of this improvement might come from agriculture, essentially manufacturing trade will have to bear the brunt of the improvement. This will simply be the converse of the experience since 1980, when the deterioration of the current account was matched one-for-one by manufacturing's plunge into deficit.

Manufacturing trade will, in fact, have to do more than simply return to the near-balance of the 1970s. Manufacturing trade must move into substantial surplus. The reason is that the United States is rapidly accumulating foreign debt. If the United States is to restore current account balance, it must run a non-interest current account surplus large enough to service that debt -- just as Brazil and Mexico do today. The main component of the surplus will almost surely be a trade surplus in manufactures.

In an effort to make our argument more concrete, we have developed a model of the U.S. economy expressly designed to estimate the role that manufacturing has to play in bringing about a balance on current account. The model is briefly described in the final section of the paper. The results obtained are shown in table 3. In each of the last three columns we have supposed that the U.S. current account moves into balance by a specified date -- 5, 10, or 15 years from now. We suppose that the trade deficit declines linearly and moves into surplus from 1986 onward at a rate just sufficient to achieve that target, taking into account the growing U.S. debt to foreigners along the way. We then calculate the trade balance in manufactures that will be necessary to achieve an overall current account balance. The table makes it clear that if the United States is not to experience explosive growth in foreign debt, our trade in manufactures must move from huge deficit to substantial surplus.

Table 3

Trade Surplus Required to Bring the U.S. Current Account into Balance

Billions of Dollars

		Amount Required to Balance Current Account by Target Year		
Year	1985	1991	1996	2001
Nonfactor Current Account Balance (Balance of Payments Concept)	−142.6	21.6	49.6	74.2
Manufacturing Trade Balance	−101.4	62.1	102.5	143.3
Assumptions: Real Annual Growth in GDP			2.5%	
Inflation Rate			3.0%	
Real Interest Rate			4.0%	

Source: Authors' calculations

The Problem

We have now argued that the United States will not cease to be a manufacturing nation; indeed, it will experience a sharp reversal of its slide into manufacturing deficit, becoming a net exporter of manufacturing by sometime in the 1990s. Doesn't this mean that worries about the manufacturing sector are therefore misplaced?

The answer is no. We have asserted that a restoration of U.S. balance in manufacturing trade must take place, but we have not yet explored the costs of that restoration. The problem facing the United States is that the costs of moving into manufacturing trade surplus will be very substantial.

Even if there were no long-term problems with manufacturing performance, the United States would face a difficult transition period. In recent years this country has taken advantage of capital inflows and an overvalued dollar to engage in a consumption boom that has far outstripped the growth in our real production. We are now faced with the necessity of bringing our spending back in line with our income, implying much slower growth in consumption in the future than in the past.

The longer-term issues of U.S. performance in manufacturing will reinforce these costs. Because of U.S. problems with productivity, technology, and quality, in order to balance U.S. manufactures trade, the dollar must fall relative to other currencies substantially below historical levels. Exacerbating this problem will be the damage done to U.S. market position by the sustained strength of the dollar; markets lost during the early 1980s will not easily be regained. To restore the U.S. position will probably require not simply a fall of the dollar to a long-run sustainable level, but a period of "corrective undervaluation" that allows the United States to regain markets.

The focus of debate, therefore, should not be on whether the United States will cease to manufacture goods -- it won't. It should be on how this country is going to cope with the strains and minimize the damage as the artificial prosperity of the mid-1980s comes to an end.

National Income and Expenditure - The required squeeze on U.S. resources can be best understood by comparing two numbers: real gross domestic product (GDP), and a less familiar number that we can call real gross domestic expenditure (GDE). GDE is the total quantity of goods and services purchased by U.S. residents, whether for consumption, government uses, or investment. (The same concept is referred to in international monetary theory as absorption.)

Chart 8 compares the growth in U.S. GDP with that of GDE from 1980 to the third quarter of 1986. The more rapid growth of GDE was made possible by two factors: a growing current account deficit, and an improvement in U.S. terms of trade. Neither is sustainable. The current account deficit must eventually end, and the fall in the dollar that will accomplish this will worsen the U.S. terms of trade. Thus, whereas in the first half of the 1980s U.S. real spending could grow faster than U.S. real production, in the future the reverse must be true.

Furthermore, the extent of the required downward adjustment will be larger than the cumulative effects of the divergence between GDP and GDE from 1980 to 1986, which resulted in a difference between the two of 5.4 percent.

Most directly, the United States will be a major debtor by the time current account balance is restored, requiring that the non-factor current account balance be in surplus, not in deficit as in 1980; to achieve this surplus will require a weaker dollar, and hence the debt service burden will be reinforced by worsened terms of trade. At the same time, the United States faces what looks like persistent weak demand in important export markets, due to the Third World's debt problems and European unemployment; this will require a still lower dollar to achieve any given trade surplus, and hence a greater drag in terms of trade. Finally, the microeconomic problems we discuss below mean that the U.S. manufacturing sector needs even lower relative labor costs, and hence an even weaker dollar, than that required by the factors we have mentioned so far.

The future squeeze on resources available for U.S. investment and consumption, then, will be significantly larger than the 5.4 percent "bonus" enjoyed in 1986. Our simulation exercises, reported subsequently, suggest that the cost of restoring competitiveness may exceed 6 percent of GDP. We regard these estimates as relatively optimistic.

Saving and Investment - The problem of a squeeze on U.S. resources is exacerbated by the problem of financing investment. In recent years, capital inflows have enabled the United States to maintain net investment despite very low national saving. The relevant and familiar facts are given in table 4. The U.S. saving share has declined sharply because of massive dissaving by the federal government. Investment could be maintained only because capital inflows have filled the gap.

Table 4

Sources of Net Investment in the United States

Percent of GDP

	Business Cycle Peak Years			
	1969	1973	1979	1985[a]
Net Investment	7.8	9.0	7.7	5.7
Net National Saving and Statistical Discrepancy	8.0	9.6	7.8	2.8
Foreign Capital Inflow	−.2	−.6	−.1	2.9

[a] Most recent year for which data available. The expansion that began in 1983 continued into 1986.

Source: *Survey of Current Business.*

With the end of capital inflows, this solution will no longer work. A sharp cut in the ratio of investment to GDP hardly seems possible; indeed, given dismal U.S. productivity performance, a *rise* in this ratio seems called for. Even to hold investment in line with GDP, however, national saving must rise. Otherwise real interest rates will rise, choking off investment and further worsening the competitive position of U.S. manufacturing.

This means that as the resources available for domestic consumption and investment are squeezed by the need of the United States to restore a balance on current account, all, and probably more than all, of the squeeze must be borne by consumption.

Microeconomic Problems - The adjustment problem of the United States may be significantly worsened by two kinds of microeconomic problems.

On one side, there is the long-term poor performance that we noted above. During the 1970s the United States seemed to need a progressive reduction in labor costs relative to other countries in order to hold its own in world markets. There is every reason to believe that under the dust cloud thrown up by currency gyrations from 1980 to 1985, this long-term problem continued. Thus, all other things being equal, the United States would need a dollar decline not simply large enough to restore its relative unit-labor-cost position of 1980, but large enough also to make up for the deterioration in the U.S. technological and quality position in the interim.

There is also widespread concern among businessmen -- concern that we share -- that the huge overvaluation of the dollar may have done long-term damage to the U.S. competitive position. During the period of the strong dollar, foreign firms have established "beachheads" in U.S. markets that they may be able to maintain even with a lower dollar; conversely, U.S. firms have abandoned markets that they will now find too costly to recapture even with the dollar back to its historical levels. Multinational firms have shifted sourcing out of the United States, and will not always shift it back just because previous exchange rates have been restored. In the currently fashionable jargon of economists, we suspect that there may be substantial "hysteresis" in the trade balance.

Both these microeconomic arguments indicate that the dollar will have to fall further than anyone has yet been willing to contemplate seriously. We need to think, not in terms of what the dollar used to be worth, but of where the declining trend of the 1970s would have put us by 1990; and from this value we need to subtract a corrective undervaluation sufficient to undo the damage of the 1980-1985 overvaluation. The further the dollar must fall, however, the greater the drag of the terms of trade on gross domestic expenditure.

The Protectionist Fallacy - The costs of restoring U.S. current account balance are going to be high. Many people will doubtless look for an easy out, a way to avoid these costs. A tempting answer will be protectionism: use tariffs and import quotas to roll back the trade deficit, and thus avoid hard choices on taxes, spending, and consumption. In fact, however, protectionist measures will only make the adjustment harder.

The central reality is that the need to bring expenditures in line with domestic production cannot be avoided. Protectionist measures can only shift expenditures from one good to another; if overall expenditures are too high, they must be reduced, regardless of U.S. trade policy.

All that protection can do is shift demand from foreign to domestic goods. For this purpose, however, it is far better to rely on dollar depreciation. Protectionist measures are inefficient because they distort incentives; they open the door to political abuse; and they will inevitably provoke retaliation from abroad.

In discussions of the problem of U.S. competitiveness, it is too often assumed that those who are concerned about competitiveness are always protectionists. This is just another example of the sterility into which the debate has fallen. The United States has a real competitive problem, but protection cannot solve it.

Restoring Competitiveness - Although several factors have contributed to the enormous problems the United States now faces, a principal one has been the insidious and chronic decline of U.S. manufacturing competitiveness. Repeated devaluation of the dollar, no matter how necessary to arrest the explosive accumulation of foreign liabilities of the United States, is not a satisfactory solution. A short-term decline in the standard of living of the American people is inevitable. But, unless we restore the competitive position of our manufacturing industry, the short-term decline will become permanent.

Many things will have to change in order to restore industrial competitiveness, ranging from attitudes and education to rates of capital formation. But none is more essential, yet more difficult to achieve, than to bring the rate of net national saving somewhere between what it was in the United States and what it is in Japan. This certainly means a doubling and possibly a quadrupling of the current rate of net national saving.

Adjustment Scenarios

As mentioned earlier, we have developed a model that allows us to illustrate plausible paths of the U.S. economy under various scenarios leading to restoration of a balance on current account. This model is deliberately based on optimistic assumptions.

In particular, the model does not take account either of a further decline in the competitiveness of U.S. manufacturing or of the long-term damage done by the strong dollar in the early 1980s. Thus, our results represent the most favorable to be expected. For example, we suspect that the dollar will have to decline more than our calculations show, the deterioration in the terms of trade will be larger, and, therefore, the required trade surplus in manufactures in real terms will have to exceed what we report.

Structure of the Model - The model (described in detail in the appendix) is essentially a simple general equilibrium model with only one domestic factor of production and four goods: domestic and foreign manufactures and nonmanufactures. It takes account of both substitution between manufactures and nonmanufactures, and substitution between domestic and foreign goods of each type. It also takes account of the input-output relations in the economy so that direct demand for manufactures indirectly produces some demand for nonmanufactures, and vice versa.

The parameters of the model represent a mix of plausible guesses drawn from the literature and real data. We use the 1977 input-output table to derive the input-output structure, and calibrate the model so that it reproduces actual numbers of 1985.

The model allows us to specify two exogenous variables. First is the real gross domestic product, that is, the economy's productive capacity, and second, the non-factor current account. Given these, we can solve for the level of real gross domestic expenditure and the real exchange rate that will produce the specified results. We can also determine the breakdown of the trade balance betwen manufactures and nonmanufactures, as well as the domestic output of each kind of good.

Hypothetical Scenarios - Table 5 reports the results of three scenarios constructed using our model. Several common assumptions are maintained across the scenarios. First, inflation is assumed to be 3 percent and the real interest rate 4 percent. Second, the non-factor current account is assumed to move into surplus linearly so as to balance the overall current account by a target date. In the first column the target date is five years from 1986; real GDP growth is assumed to be 2.5 percent per year. In the second column the target year is again five years from 1986 but GDP is assumed to grow at 3 percent per year. In the third column the target year is 10 years from 1986 and GDP is assumed to grow at 2.5 percent as in the first scenario.

Table 5

Three Hypothetical Scenarios

Resulting in a Zero Current Account Balance by Target Year

		Target Years		
	1985	1991	1991	1996
Percent of Gross Domestic Product:				
(1) Nonfactor Current Account	−3.6	.4	.4	.7
(2) Manufacturing Trade Balance	−2.6	1.1	1.1	1.3
		1986 to Target Year		
	1980–85	1991	1991	1996
Percent Change:				
(3) Terms of Trade	16.9[a]	−20.2	−20.1	−21.1
Average Annual Growth Rates, Percent:				
(4) Gross Domestic Product	2.5	2.5[b]	3.0[b]	2.5[b]
(5) Gross Domestic Expenditures	3.5	1.2	1.7	1.8
(6) Manufacturing Output	3.1	4.3	4.8	3.4
(7) Non-manufacturing Output	2.4	2.0	2.5	2.3

[a] Excludes agricultural export prices and petroleum import prices.

[b] By assumption. Inflation rate assumed to be 3 percent, real interest rate 4 percent.

Source: Authors' calculations.

The first line of the table shows the non-factor current account surplus that will be required in each case as a share of GDP. The important point here is that the United States will have to adjust well past its 1980 position, which was one of a significant deficit in the non-factor current account. If the current account is to be in balance by 1991, the surplus will have to be nearly one-half of 1 percent of GDP. The longer the adjustment is allowed to take, the larger the accumulation of foreign debt and thus the larger the required non-factor surplus.

The second line of the table shows the required surplus in manufacturing trade as a share of GDP. This line makes the point that the required improvement in the trade position must come largely through an improvement in manufacturing trade.

The third line of the table shows the required decline of the terms of trade from current levels. As we have explained, we regard this number as a likely underestimate, perhaps a serious one, of the actual decline that will be required.

The terms-of-trade change will increase the demand for U.S. goods. Since productive capacity is limited, domestic demand will have to grow more slowly than GDP. Lines 4 and 5 of the table show the rates of growth of real GDP and

GDE. Note that if the current account is to be balanced by 1991, real domestic demand must grow less than half as rapidly as real domestic output.

Finally, lines 6 and 7 show the effect on the structure of the economy of the combination of slow growth in domestic demand and improving trade balance. In order to balance its payments, the United States must experience a significant reindustrialization, with manufacturing output growing significantly faster than the nonmanufacturing sector.

The picture presented by these scenarios is far from catastrophic (although we suspect that the true picture may be worse). Nonetheless, it is fairly bleak. We have assumed a path in which output grows fast and smoothly, without any recession, and in which the United States is, in fact, able to regain markets without getting caught in a trade war or any other sort of crisis. Nonetheless, we find that our international competitive problem may easily be enough to prevent any rise in living standards for quite some time.

Conclusion

The United States has a serious international competitive problem and that problem is largely one of competitiveness in manufacturing. The problem is, however, not one of impending deindustrialization. Rather, it is that the inevitable improvement in the U.S. trade balance, which will necessarily come mostly in manufactured goods, will impose serious costs on the U.S. economy. These costs will be higher than they would otherwise be because of the poor performance of U.S. manufacturing in international competition.

It is important that the United States begin to face up to the magnitude of the adjustment problems ahead. As a first step we need to get away from the sterile debating positions that have led discussions of the state of U.S. manufacturing to an impasse. It is easy for businessmen to fault economists for their lack of contact with what is really happening; it is equally easy for economists to fault businessmen for their lack of understanding of how the pieces of the picture fit together. We hope this paper helps convince both sides to listen to what the others are saying. Unless this happens, the United States will not be able to face the coming difficulties with the foresight they deserve.

* * * * * *

Appendix: Structure of the Simulation Model

The numerical exercises reported in this paper were derived from a simple general equilibrium model calibrated to U.S. data. This model allows us to keep track of the changes in relative prices, resource allocation, and real income associated with changes in the trade balance.

The model simplifies issues in four major ways. First, specificity of resources to particular sectors is ignored: the economy is treated as having only one domestic factor, which can produce value added in any sector. Second, differences in the composition of different kinds of demand are ignored:

investment, consumption, and government purchases are assumed to embody the same mix of manufactured (MAN) and nonmanufactured (NON) goods, and the same ratio of domestic to foreign products within each category. Third, the model is highly aggregated, with only four goods recognized: domestic manufactures (DMAN), foreign manufactures (FMAN), domestic nonmanufactures (DNON), foreign nonmanufactures (FNON). Finally, continuous maintenance of normal employment of resources is assumed: the possibility of a recession that leaves resources underutilized is ignored.

Despite these simplifications, the model is by no means trivial. We keep full account of input-output links between sectors, and impose a structure that forces us to tell a fully consistent story about the relationships among all elements of the economy.

Demand in the model is represented by a two-level CES (constant elasticity of substitution) structure. At the top level, the economy's true absorption of goods and services -- real gross domestic expenditure -- is a CES function of absorption of manufactured and nonmanufactured goods:

$$\mathrm{GDE} = \mathrm{GDE}(\mathrm{MAN},\mathrm{NON}) \qquad (1)$$

A low elasticity of substitution of 0.1 is assumed at this level. The constant terms, here and elsewhere, are chosen so as to reproduce the actual values for 1985.

At the second level, the aggregates of manufactured and nonmanufactured goods are themselves CES functions of domestic and foreign goods of each type:

$$\mathrm{TMAN} = \mathrm{TMAN}(\mathrm{DMAN},\mathrm{FMAN}) \qquad (2)$$

$$\mathrm{TNON} = \mathrm{TNON}(\mathrm{DNON},\mathrm{FNON}) \qquad (3)$$

where TMAN, TNON are total supplies of each type of good to the economy; DMAN, DNON are domestic outputs; and FMAN, FNON are imports. The elasticity of substitution between domestic and foreign goods is assumed equal to 2 in manufacturing, 0.1 in nonmanufacturing.

Total demand for manufactures and nonmanufactures in the economy reflects both direct demand for final use and exports (XMAN and XNON) and direct demand by domestic producers:

$$\mathrm{TMAN} = \mathrm{XMAN} + \mathrm{MAN} + a_{11}\mathrm{DMAN} = a_{12}\mathrm{DNON} \qquad (4)$$

$$\mathrm{TNON} = \mathrm{XNON} + \mathrm{NON} + a_{21}\mathrm{DMAN} + a_{22}\mathrm{DNON} \qquad (5)$$

where the coefficients a_{ij} are taken from the 1977 input-output table.

Export demand depends on the price of each kind of good relative to foreign prices:

$$\mathrm{XMAN} = \mathrm{XMAN}(\mathrm{PMAN}/\mathrm{PFMAN}) \qquad (6)$$

$$\mathrm{XNON} = \mathrm{XNON}(\mathrm{PNON}/\mathrm{PFNON}) \qquad (7)$$

The elasticity of foreign demand for manufactured goods is set equal to 1.5, while that for nonmanufactures is set equal to 0.5.

Prices of manufactures and nonmanufactures aggregates are the cost-minimizing solutions, given the prices of domestic and foreign goods. The price of domestic goods (PDMAN and PDNON) reflects the prices of value-added, set equal to one, and the prices of inputs of the manufactured and nonmanufactured aggregates (PMAN and PNON):

$$PDMAN = (1 - a_{11} - a_{21}) + a_{11}PMAN + a_{21}PNON \quad (8)$$

$$PDNON = (1 - a_{12} - a_{22}) + a_{12}PMAN + a_{22}PNON \quad (9)$$

The prices (PFMAN and PFNON) of foreign goods depend on the exchange rate E:

$$PFMAN = PFMAN(E) \quad (10)$$

$$PFNON = PFNON(E) \quad (11)$$

We assume that the elasticity of both foreign prices to the exchange rate is the same; given this, the U.S. adjustment path does not depend on what this elasticity is. For the sake of concreteness, however, an elasticity of 0.6 is assumed.

Finally, we define two useful aggregates. First is the U.S. balance in goods and nonfactor services (B), defined as

$$B = PMAN*XMAN + PNON*XNON - PFMAN*FMAN - PFNON*FNON \quad (12)$$

Second is real GDP, defined as the sum of value-added:

$$GDP = (1 - a_{11} - a_{21})*DMAN + (1 - a_{12} - a_{22})*DNON \quad (13)$$

The model allows us to solve for B and GDP given GDE and the exchange rate E. We have inverted this procedure. We assume a growth rate for real GDP and calculate a path for B that yields current account balance after a specified number of years. We then solve the model for the levels of GDE and E that yield these results. As a byproduct the model also then yields domestic output of manufactured and nonmanufactured goods, and the trade balance by type of good.

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REPORT

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Yen Surges To Record Highs

Despite the February 22 agreement calling for exchange rate stability, the dollar resumed its slide in late March, falling to a post-World War II record low. The decline, which followed two months of relatively stable currency values, came despite massive joint intervention in exchange markets by the central banks of the major industrial countries. The volatility spilled over into world financial markets, as stock and bond prices plunged amid fears of higher U.S. interest rates. As of March 25, the yen had risen 70 percent on a trade-weighted basis since the end of February 1985 (see Table).

The pressure on the dollar was the first test of February's Group of Seven agreement stating that exchange rates were roughly consistent with underlying economic fundamentals (see JEI Report No. 8B, February 27, 1987). To maintain currency stability the central banks of the United States, Japan, West Germany, France and Britain purchased an estimated $6 billion during the week of March 23-27. Even this large-scale intervention was unable to reverse the dollar's downward trend in global currency markets, which trade as much as $250 billion a day.

Changes in Yen Relative to Currencies of Major Trading Partners

Currency of*	Share of Japan's trade in 1986**	Percentage change from end of February 1985 to March 25, 1987
United States	32.6%	73.9%
Republic of Korea	4.7	75.8
China	4.6	128.4
West Germany	4.4	-4.3
Taiwan	3.7	52.1
Australia	3.6	78.6
Canada	3.1	64.9
Britain	3.0	18.5
Indonesia	3.0	162.3
Hong Kong	2.5	73.9
Saudi Arabia	2.4	82.5
United Arab Emirates	2.1	74.0
Singapore	1.8	64.5
Malaysia	1.7	69.5
Soviet Union	1.5	28.0
France	1.5	3.8
Switzerland	1.3	-6.3
Netherlands	1.1	-4.9
Thailand	1.0	60.3
Belgium	0.9	-1.9
Trade-weighted average		70.0

*Since March 1987 inflation rates are not available for most countries, all percentage changes are calculated using nominal exchange rates. Admittedly, it is real, not nominal rates, that affect trade flows. For the countries listed above, though, changes in nominal exchange rates have closely paralleled changes in real rates.

**The top 20 trading partners listed above accounted for 80.6 percent of Japanese trade (exports plus imports) in 1985. The weighted average change in the exchange rate is based on 1985 and 1986 shares of trade.

Source: International Monetary Fund and the Wall Street Journal

Traders attributed part of the dollar's decline to seasonal factors. It is common for Japanese exporters to sell dollars to repatriate profits prior to the end of their fiscal year on March 31. Market participants also pointed to Treasury Secretary James Baker's comment March 22 that Washington had no target for the dollar, which seemed to contradict the February agreement. Some observers speculated that the United States had repudiated the pact in frustration at Japan's failure to adopt policies to stimulate its economy. In congressional testimony March 25, though, Mr. Baker held that he supported the accord and rejected any suggestion that Japan and West Germany had failed to fulfill their commitments to boost their economies.

Despite an estimated $2 billion in purchases by the Bank of Japan, the dollar fell to a record closing low of Y146.2=$1.00 on March 30. The decline was attributed to the dispute over semiconductor trade and concerns that the U.S. decision March 27 to retaliate against Japanese electronic exports could escalate into a full-scale trade war (see article in this issue).

Business leaders reacted with alarm to the the yen's rise above the Y150 level. According to the daily Nihon Keizai Shimbun, a rise from Y150 to Y140=$1.00 would lower Japan's real growth rate in FY 1987 (April 1, 1987-March 31, 1988) by 0.6 percentage point. The Nikkei index of 225 stock prices suffered its second-worst drop on record March 30, led by declines in the stocks of export-oriented companies. Keidanren called its first emergency meeting in a more than a decade to discuss the yen's latest surge, which chairman Eishiro Saito termed a "shock that will shake the very foundations of the Japanese economy." There were also numerous calls for the government to stimulate domestic demand.

Finance Minister Kiichi Miyazawa has urged that Tokyo move quickly to stimulate the economy. The Economic Planning Agency plans to finish the outline of a stimulus package prior to the prime minister's trip to the United States on April 29. Some influential Liberal Democratic Party leaders want the package to mark a fundamental change in fiscal policy.

Randall S. Jones

Financial Affairs Update

Amidst the chaos caused by the yen's continuing rise against the dollar, there are numerous signs that Japan's financial firms are prospering. At the same time, financial institutions and monetary policymakers are restructuring domestic markets and becoming more involved in markets abroad, just as foreign financial companies are finding more opportunities in Tokyo.

According to a survey by the Nihon Keizai Shimbun, the pretax current profits of 135 financial institutions for the year ending March 31, 1987 will total just under Y4.6 trillion ($30.7 billion at Y150=$1.00), a gain of 36 percent. In contrast, the manufacturing sector expects a 24 percent decline in profits to just under Y4.2 trillion ($28 billion), the second annual drop in a row. The shift in Japan's economic structure is clear: while the manufacturing sector accounted for half of total industrial profits in FY 1984, its contribution is expected to drop to 34 percent in fiscal 1986. Conversely, the nonmanufacturing segment will gain another 10 points to contribute 66 percent of all profits, with financial firms holding a 37 percent share.

The ascendency of financial firms is underscored by the appearance of Japan's Big Four securities houses in the top 10 corporations ranked by pretax profits. Although Toyota Motor Corp. held on to first place, Nomura Securities Co., Ltd. (second), Daiwa Securities Co., Ltd. (fifth), Nikko Securities Ltd. (eighth) and Yamaichi Securities Co., Ltd. (tenth) displaced such industrial giants as Hitachi, Ltd., Nissan Motor Co., Ltd. and Matsushita Electric Industrial Co., Ltd. The brokerage houses benefited from both the tremendous surge in foreign investment and the dramatic rise of the Tokyo stock market.

& Co. and Salomon Brothers Inc. have opened such accounts. As of July 1986 the foreign syndicate members had only successfully bid to underwrite 0.07 percent of outstanding Japanese government bonds, estimated at Y136.3 trillion ($908.7 billion). The syndicate leadership is also considering raising the share of the primary 10-year bond market allocated to foreign firms from 1.19 percent to 5.7 percent. Finally, MOF is planning to issue six-year bonds to bolster the medium-term market against competition from the short-term bond market, which offers instruments with maturities of two, three and four years.

Over-the-counter sales of government bonds at most of Japan's 20,000 post offices will begin October 1 under an agreement between the Ministries of Finance and Posts and Telecommunications. The two have set a limit of Y5 million ($33,333) for primary purchases in order to limit the competition between private bond outlets and the post offices. Secondary transactions, however, will be unregulated. Funds currently held in tax-exempt savings accounts cannot be directly converted to bonds, and while interest earned on bonds may be paid directly into an ordinary savings account, the post offices may not create a financial instrument combining bonds with fixed deposits. The postal savings system has been allotted Y2 trillion ($13.3 billion) worth of bonds in fiscal 1987 and will be permitted to use any unpurchased bonds as collateral to make loans of up to Y2 million ($13,333) per individual. When this change goes into effect, bond markets will undoubtedly show another spurt of activity.

The Ministry of Finance may be on the verge of allowing Japanese firms to invest in foreign financial futures. While trading in domestic futures has been allowed for about 18 months, the volume has already surpassed trades in Treasury bond futures on the Chicago Board of Trade. To date, Japanese financial institutions have only dabbled in foreign futures but have been pressuring MOF to lift its restrictions. MOF is considering limiting foreign futures trading to those based on a Japanese firm's own instruments, but Americans are hopeful that the ministry will permit trading in Treasury bond futures because of the significant amount of Japanese investment exposed to bond market fluctuations. MOF has not announced a date for its decision.

Finally, MOF has decided to allow U.S. banks to open securities subsidiaries in Japan under certain conditions. The parent bank's stake in the subsidiary must be no greater than 50 percent and the remaining equity must come from a non-financial institution. Tokyo has allowed 11 European universal banks to open securities units, and several U.S. banks, including Morgan Guaranty Trust Co., Bankers Trust Co., Chemical Bank and Manufacturers Hanover Trust Co., have been negotiating with the ministry for similar access. While no date for granting the American firms the necessary licenses has been set, MOF is touting the move as another important step toward liberalization.

Jon Choy

The Source Of International Trade Imbalances

Economists have increasingly focused on Japan's high saving rate and its shrinking government budget deficit as the underlying causes of its huge current account surplus. According to a well-known national income accounting concept, a nation's current account balance equals its private-sector balance (saving minus investment) plus the government balance. In Japan's case, the failure of business investment and the public sector to absorb household savings has left a surplus to invest abroad. The reverse side of this capital outflow is a large trade surplus.

Japan's current account surplus ballooned from $4.8 billion in 1981 to $86 billion last year. The U.S. balance has moved in the opposite direction, swinging from a $6.3 billion surplus in 1981 to a $140.6 billion deficit in 1986. Personal savings in this country have been insufficient to fund both private investment and large government deficits. After four years of huge capital inflows and matching trade deficits, protectionist pressures in Washington have surged, leading to friction with the nation's major trading partners, particularly Japan.

If Japan were the source of the unprecedented international imbalances, one would expect to see an across-the-board improvement in its trade position. Tables 1 and 2 support the conclusion that the United States is primarily responsible, although lower oil prices also played an important role. The United States and the Organization of Petroleum Exporting Countries accounted for more than three-fourths of the increase in Japan's trade surplus between 1981 and 1986. Trends in its trade balance with the rest of the world, meanwhile, have been mixed. Larger surpluses with the European Community and the newly industrialized countries of Asia have been partially offset by a deterioration in the balance with Latin American and Communist bloc nations.

The U.S. trade position, in contrast, deteriorated with every trading region except OPEC between 1981 and 1986. While Japan accounted for the largest share of the $130 billion rise in the U.S. trade deficit, the European Community, the newly industrialized countries, Canada and Latin America also played important roles. In addition to the strong dollar resulting from the domestic saving-investment imbalance, the rise in the U.S. trade deficit reflects the Third World debt crisis and the faster rate of growth in this country than in most of its trading partners.

Randall S. Jones

Table 1: Japan's Trade Balance, 1981 and 1986

(in billions of dollars, exports f.o.b., imports c.i.f.)

	1981 Trade balance	1986 Trade balance	Increase in surplus	Share of increase in Japan's surplus
United States	$13.3	$51.4	$38.1	51.5%
OPEC*	-32.1	-12.4	19.7	26.6
European Community	10.3	16.7	6.3	8.6
Newly industrialized countries**	12.3	17.5	5.2	7.1
China	-0.2	4.2	4.4	5.9
Other developed countries	-1.3	0.8	2.1	2.9
Communist bloc***	2.0	1.6	-0.4	-0.5
Latin America	3.8	3.3	-0.5	-0.7
Other developing countries	0.5	-0.5	-1.0	-1.3
Total	8.7	82.7	74.0	100.0

*Excludes Venezuela and Ecuador.
**Includes Taiwan, Korea, Hong Kong and Singapore.
***Excludes China.

Source: Ministry of Finance

Table 2: U.S. Trade Balance, 1981 and 1986

(in billions of dollars, exports f.a.s., imports c.i.f.)

	1981 Trade balance	1986 Trade balance	Increase in surplus	Share of increase in U.S. deficit
Japan	$-18.1	$-58.6	$40.5	31.1%
European Community	8.7	-26.4	35.1	26.9
Newly industrialized countries*	-7.0	-30.8	23.8	18.3
Canada	-7.3	-23.3	16.1	12.3
Latin America	1.3	-13.0	14.3	11.0
Other developed countries	5.3	-5.1	10.4	8.0
Communist bloc***	4.2	-2.3	6.5	5.0
Other developing countries	2.9	-2.8	5.7	4.4
OPEC**	-29.7	-7.4	-22.3	-17.1
Total	-39.6	-169.8	130.2	100.0

*Includes Taiwan, Korea, Hong Kong and Singapore.
**Excludes Venezuela and Ecuador.
***Excludes China

Source: Department of Commerce

Reagan Orders Retaliation For Japan's Semiconductor Trade Practices

The Reagan administration has made good on its January 28 threat to retaliate against Japan if Tokyo did not quickly implement the semiconductor settlement agreement hammered out this past July. Asserting that Japanese manufacturers were still dumping in third markets and that American suppliers did not have any better access to the Japanese market now than last fall, the president announced March 27 that the United States would slap 100 percent penalty tariffs on $300 million worth of Japanese-made products to offset the sales lost by this country's semiconductor industry because of unfair Japanese trade practices. Japanese government officials made an eleventh-hour attempt to convince the White House that Tokyo was doing everything possible to live up to its side of the pact, but this effort did not produce the last-minute deal that had obviated retaliation by Washington in all the other equally high-profile trade clashes between the United States and Japan.

Although Mr. Reagan's decision to go the trade sanctions route was unprecedented in bilateral relations, few Washington observers were surprised by the move. They argue that the White House simply had too much at stake politically to back down after threatening retaliation. For starters, the administration spent a year trying to work out a way to settle the unfair trade practices petition filed by the Semiconductor Industry Association under Section 301 of the 1974 Trade Act and the dumping complaints brought against Japanese manufacturers of 256K DRAMs (dynamic random access memories) and EPROMs (erasable programmable read-only memories). Then when an agreement was in hand, U.S. trade policymakers went to great lengths to assure skeptical American merchant semiconductor manufacturers that their Japanese competitors were

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JAPAN AND ASEAN: POLITICAL AND ECONOMIC RELATIONS

Summary

As Japan's global power has expanded, its importance to the economies of the six ASEAN countries has also increased. In trade, investment and aid flows, Japan has become the primary foreign economic presence in most of these nations. Although it has maintained a low profile in political issues, Tokyo has begun during the last decade to offer the region a measure of political cooperation. While its economic and political support are welcome, inherent tensions have caused dissension in both areas. This report will examine the major issues facing the region as well as the reasons behind Japan-ASEAN disputes.

Introduction

Japan has long placed the maintenance of close relations with Southeast Asian countries on its priority list. After World War II Tokyo chose to pursue this goal primarily through economic means, while keeping a low political profile. This strategy has, for the most part, been enormously successful. Japan was able to break through the Western colonial influence in these countries and establish itself as the number-one foreign economic presence. Southeast Asian nations, in turn, began to look to Japan for the growth that economic assistance and investment can bring.

In 1967 five countries -- Thailand, Singapore, Malaysia, the Philippines and Indonesia -- formed the Association of Southeast Asian Nations. Brunei joined the organization in 1984. Because these nations have similar economies (with the exception of Singapore), political views and development goals, the association serves as a forum to develop complementary policies. Moreover, the organizational structure that combines the voices of the six members often carries more weight with developed countries than the views of individual countries.

Still, ASEAN remains far from unified -- and is nowhere near achieving the cohesion that the European Community enjoys. National interests continue to outweigh the members' commitment to regional interests. In fact, regional policies normally develop only from those issues that coincide with or advance national goals. Coordination of economic policies is made more difficult by the fact that these nations produce similar goods (including a rich supply of primary products) and most have adopted import-substitution development policies. As an ASEAN task force report noted, this makes their economies more complementary with the developed nations rather than with fellow ASEAN members.

As the most developed nation in the region -- and with the advantages of geographical proximity and a degree of cultural similarity -- Japan became a major player in the economies of Southeast Asia during the 1960s. Japan relied on the region for raw materials, including petroleum (Indonesia), tin (Indonesia, Malaysia and Thailand), copper (the Philippines), nickel and bauxite (Indonesia). At the same time, it increased investments in and exports of manufactured goods to the region. As its influence grew, the Southeast Asian countries began to complain of Japanese economic domination. Tensions multiplied, culminating in anti-Japanese riots and demonstrations in Bangkok and Djakarta during Prime Minister Kakuei Tanaka's 1974 tour of the region.

Confronting these disheartening signals during the 1973-74 oil crisis, Tokyo reconsidered its ASEAN policy. Then-Prime Minister Takeo Fukuda unveiled a new plan during his 1977 visit -- the "Fukuda Doctrine." To encourage the development of "heart-to-heart relations," he promised to increase Japanese economic assistance and participation in joint ventures, promote cultural understanding and increase Japan's imports from the region. In launching the doctrine, he pledged $1 billion to finance large industrial projects jointly owned by the ASEAN members.

ASEAN countries, apprehensive about the recent military withdrawal of the United States from the region and anxious for assistance in their development plans, welcomed the change, which has for the most part remained in effect since then. During Prime Minister Zenko Suzuki's 1981 tour of the region, he introduced a slight rhetorical modification, calling for the "politics of harmony" between Japan and ASEAN. Last year Foreign Minister Shintaro Abe reiterated Tokyo's position when he presented the "Abe Doctrine" -- a renewal of earlier promises as well as support for "heart-to-heart relations" and a "creative partnership."

Significant problems remain, however. Although there is a strong ASEAN lobby in Tokyo today, specific goals can be hard to develop. Japan's desire to support the organization is hindered by the fact that the ASEAN position is often unclear. Since the members themselves are often ambivalent, Tokyo has to deal with indecision and slow policy development. Nonetheless, definite areas

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of agreement and disagreement can be found. Not surprisingly, there is general (but not complete) accord on political matters, particularly given Tokyo's hands-off policy in that area. It is in the economic realm that disputes are more evident.

Trade Relations

Despite the criticism leveled at Tokyo on trade issues, ASEAN has consistently run a trade surplus with Japan -- approximately $4 billion in 1986 using Japanese data (see Table 1). Bilaterally, Japan's trade is in the red with all the members except Singapore and Thailand. ASEAN takes little satisfaction in these figures, however, since the bulk of its exports to Japan consists of primary products.

Table 1: Japan's Trade with ASEAN, 1982-86

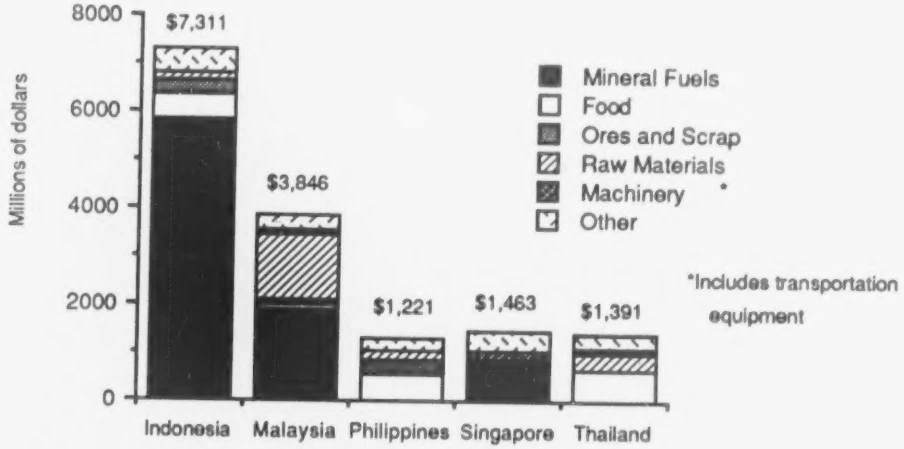
(in millions of dollars; exports f.o.b., imports c.i.f.)

	1982	1983	1984	1985	1986
Brunei					
Exports	$ 145	$ 86	$ 72	$ 90	$ 58
Imports	2,636	2,637	2,202	1,892	1,285
Trade Balance	-2,491	-2,281	-2,131	-1,802	-1,227
Indonesia					
Exports	4,261	3,552	3,073	2,172	2,662
Imports	12,005	10,432	11,175	10,119	7,311
Trade Balance	-7,744	-6,880	-8,102	-7,947	-4,649
Malaysia					
Exports	2,502	2,771	2,875	2,168	1,708
Imports	3,010	3,131	4,412	4,330	3,846
Trade Balance	-508	-360	-1,537	-2,162	-2,138
Philippines					
Exports	1,802	1,744	1,080	937	1,088
Imports	1,576	1,306	1,419	1,243	1,221
Trade Balance	227	437	-338	-306	-133
Singapore					
Exports	4,373	4,448	4,610	3,860	4,577
Imports	1,826	1,468	1,775	1,594	1,463
Trade Balance	2,547	2,981	2,835	2,266	3,114
Thailand					
Exports	1,907	2,506	2,425	2,030	2,030
Imports	1,041	1,019	1,040	1,027	1,391
Trade Balance	966	1,487	1,385	1,003	639
Total ASEAN					
Exports	14,990	15,107	14,134	11,257	12,123
Imports	22,094	19,722	22,024	20,205	16,517
Trade Balance	-7,103	-4,615	-7,887	-8,948	-4,394

Source: Japan Tariff Association, The Summary Report: Trade of Japan

No less than 87 percent of Japan's imports in 1986 consisted of food, mineral fuels (including petroleum products), metal ores and scrap, and other raw materials (see Figure 1). Of course, some countries are more dependent on primary exports than others. Virtually all of Brunei's 1986 exports to Japan fell into this category, as did 93 percent of Indonesia's, 90 percent of Malaysia's, 80 percent of the Philippines' and 74 percent of Thailand's. Even in the case of Singapore, the most developed of the ASEAN members, agricultural and industrial raw materials made up 59 percent of all shipments to Japan.

Figure 1
Japan's Imports from ASEAN Countries, 1986



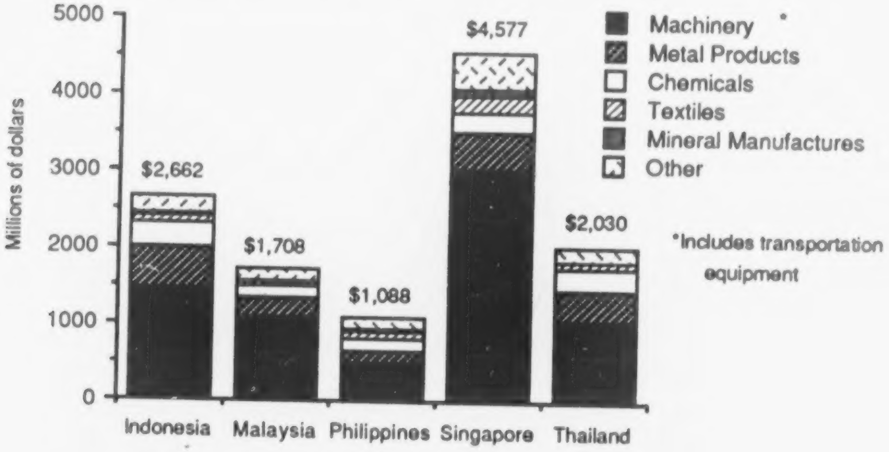
ASEAN complains that, despite Tokyo's pronouncements on "heart-to-heart" relations, it neglects the region in its attempts to assuage American and European trade complaints. For example, members point out that Japanese duties on some developed countries' primary exports are actually lower than those on similar ASEAN products. In response to these charges, Tokyo lowered tariffs in 1985 on boneless chicken (a Thai export), bananas (Philippines) and palm oil (Malaysia). While pleased by the reductions, ASEAN insisted that Tokyo's actions did not go far enough.

Their reliance on raw materials leaves the ASEAN countries in a classic predicament for developing countries: excessive vulnerability to swings in commodity prices. Given present depressed oil prices, this is an especially difficult problem for Indonesia. Moreover, sales of primary products do little to enhance economic development. As mentioned previously, countries in the region are pushing import-substitution policies that expand their manufacturing capacities.

Members would like more help from Tokyo in this respect: specifically, by increaing its imports of manufactured goods. In 1986 every ASEAN country ran a substantial trade deficit with Japan in manufactures. The total deficit (excluding Brunei) was $9.8 billion, with Singapore's $3.9 billion imbalance topping the list. The Philippines had the lowest deficit at $827 million. Some 98 percent of all Japan's exports to ASEAN countries are manufactured goods (see Figure 2). By contrast, only 13 percent of ASEAN's sales fit that category. In response to complaints in this regard, Tokyo announced in August 1986 that it would assist ASEAN in the development of export-oriented industries (see next section).

Figure 2

Japan's Exports to ASEAN Countries, 1986



To work out these and other areas of disagreement, the Japan-ASEAN Forum was launched in 1977 to provide a framework for discussions of trade and development. This institutional arrangement allows the ASEAN countries to negotiate with Japan on a multilateral basis. This benefits ASEAN more than Japan since Tokyo has been more comfortable -- and more effective -- in bilateral negotiations.

A major trade concern continues to be the volatility of ASEAN's export earnings due to the sensitivity of commodities to price fluctuations. ASEAN has proposed the estalishment of STABEX -- a system to insure the stabilization of the members' export earnings. Although the issue has been discussed periodically since 1977, nothing concrete has resulted.

Japan backs the establishment of a Pacific economic community. Although the intention would be to promote economic growth, several of the ASEAN countries are fearful that such an organization would give developed nations a stronger voice than ASEAN members. Thus, they worry that ASEAN interests will be overshadowed by those of the economically advanced nations.

Still, some have found the idea appealing and have participated in annual tripartite discussions among academics, business and government officials on the subject. As of mid-1986, national committees for these Pacific Economic Cooperation Conferences had already been set up in Japan, Thailand, Indonesia, the United States, Canada, South Korea, Taiwan, Australia and New Zealand, while other ASEAN countries were preparing to join the process.[1]

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[1] "Japan, '86," Far Eastern Economic Review, June 12, 1986.

Japan's Investment in ASEAN

In addition to the trade relationship, Japan has established a strong investment presence in the ASEAN countries (see Table 2). While the member countries have largely welcomed Japan's economic presence, they complain about its form. Given Japan's need for raw material inputs, investors have tended to concentrate on natural resource development -- especially in resource-rich Indonesia. ASEAN countries see little value in this type of venture for their development goals; they continue to urge Japan to invest in the manufacturing sector. Even so, they point out, when Japanese firms do set up manufacturing bases in their countries, it is often for offshore assembly rather than integrated production for the local market.

Table 2: Japan's Foreign Direct Investment in ASEAN, FY 1981-85

(in millions of dollars)

	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	Total March 31, 1986
Brunei	$ 5	$ --	$ 2	$ 5	$ 1	$ 107
Indonesia	2,434	440	374	374	408	8,423
Malaysia	31	83	140	142	134	1,683
Philippines	72	34	65	46	61	892
Singapore	266	180	322	225	339	2,269
Thailand	31	94	72	119	114	761
Total ASEAN	2,839	831	975	911	1,057	14,135

Source: Ministry of Finance

An equally worrisome problem is the fact that the industrialized countries are becoming more attractive to Japanese investors (see Figures 3 and 4). While Japan has been steadily increasing its investments in the United States and Western Europe, there has been no substantial increase in funds to Southeast Asia in several years -- a sign, ASEAN officials say, that Japan is "separating from Asia."[2] Consequently, several ASEAN leaders have appealed directly to Tokyo to put more emphasis on investments in ASEAN, especially in export-oriented industries.

Japan's response to the latest set of requests, made at the July 1986 Japan-ASEAN Forum, came in the form of the "New Asian Industries Plan." The plan has four goals: (1) to build up the region's export industries; (2) to decrease yen credit interest rates; (3) to promote technology transfers; and (4) to expand the Generalized System of Preferences on individual imports.[3] Tokyo has said that it plans to encourage the formation of joint ventures, emphasize infrastructure linkages, train more ASEAN engineers, and extend low-interest loans both to the ASEAN countries and Japanese firms that participate in the effort.

[2] Asahi Shimbun, October 3, 1986.

[3] Far Eastern Economic Review, January 24, 1987.

Figure 3

Japan's Foreign Direct Investment, FY 1980

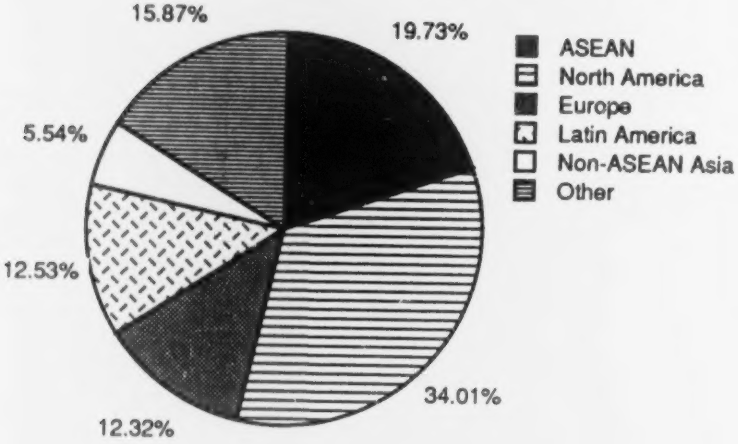
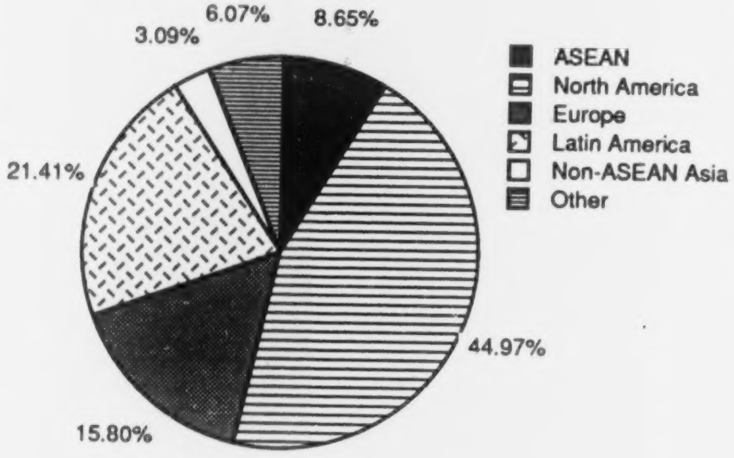


Figure 4

Japan's Foreign Direct Investment, FY 1985



In return for this initiative, Tokyo hopes to see the elimination of some investment deterrents in ASEAN countries. For example, Japanese officials want to see tax structures, domestic equity and content regulations, and other government restrictions liberalized to be more conducive to foreign investment. While there has been some positive feedback from Thailand so far, it is still unclear how quickly the other countries in the region will respond.

The Yen's Appreciation: A Mixed Blessing?

ASEAN's concern about Japan's role as a developed country has already been mentioned in the context of the Pacific Community issue. However, these concerns also extend to Japan's macroeconomic policies and other bilateral relations. Tokyo's efforts to maintain harmonious relations with the United States and Western Europe provoke some consternation since many of those efforts are seen as coming at the expense of ASEAN's regional interests. The most important change, of course, has been the appreciation of the yen against the dollar from its February 1985 low of Y263 to its current level of Y150 or so.

Since many of the ASEAN currencies are linked -- officially or unofficially -- to the dollar, the yen has appreciated substantially against them as well. For example, the yen rose almost 162 percent against the Indonesian rupiah in nominal terms between February 1985 and March 1987, 70 percent against the Malaysian ringgit, 65 percent against the Singapore dollar and 60 percent against the Thai baht (see JEI Report No. 13B, April 3, 1987).

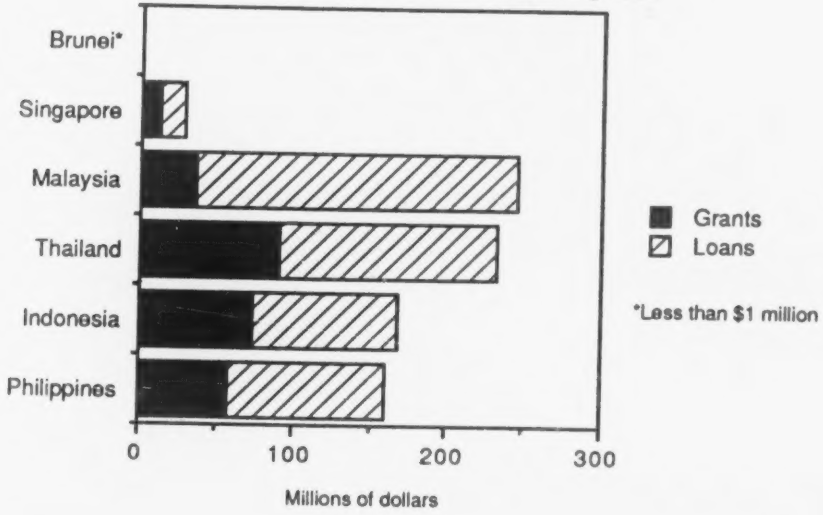
This realignment has been a mixed bag for most of these countries. The best news has been in the area of investment, which has become more attractive to Japanese investors since the yen's rise. According to a November 1986 survey of Japanese firms with overseas operations by ASEAN's Center on Trade, Investment and Tourism, nearly 30 percent of the respondents chose the region as their first investment choice. Moreover, 30 percent of the companies already operating there are considering expanding, 55 percent intend to maintain their present activities and only 10 percent are thinking of scaling down or withdrawing (see JEI Report No. 42B, November 14, 1986). Similarly, the yen's appreciation may bode well for ASEAN's trade balance with Japan. Since the adjusted exchange rates favor ASEAN exports, these countries could see an improvement in their manufactured goods sales to Japan.

On the other hand, exchange rate changes have seriously damaged those countries with large yen-denominated debts -- mainly, Indonesia and Malaysia (see Figure 5). For both these countries, which are already suffering from low petroleum prices, it is now more costly to pay the interest on their yen loans.

Malaysian Prime Minister Datuk Seri Mahathir bin Mohamad has been the most vocal about the need for a Japanese response to this problem. In late 1986 he asked Japanese officials to lower the interest rates on new loans to his country and approve other debt-alleviation measures. Tokyo has been reluctant to reduce interest rates for fear of establishing a global precedent. However, it has recently taken steps to enact an across-the-board reduction in rates (based on income) for new loans. Still, officials argue that although debtors benefited in recent years from a low yen, there was no discussion of interest rate hikes.

Figure 5

Composition of Japan's Aid to ASEAN, 1984



In addition to macroeconomic questions, ASEAN officials are watching the trade policy disputes between the United States and Japan with concern. The emphasis in Washington on the need for trade legislation, which has been directed primarily at Tokyo, has an adverse effect on ASEAN's economies as well. Congressional complaints about Japan's trade practices have been expanded to include other countries. There is a growing feeling that Japan is the model from which other countries learn "mercantilist" trade patterns. While the newly industrialized countries have borne the lion's share of this spinoff effect, the ASEAN nations are aware of the negative impact it could have on their trade relations with the United States.

Political Relations

To say that Japan has steered clear of regional political issues does not mean that it is uninterested. The security of Southeast Asia is critical to Japan. The ASEAN region is the geographical bridge from Tokyo to Southwest Asia, the Middle East, Africa and Europe. Moreover, nearly all of Japan's petroleum is shipped through the Strait of Malacca. Recently it has become evident that as Japan's economic power continues to grow, the absence of a political policy has implications in and of itself. This realization, coupled with calls from the United States for a greater international role for Tokyo, has led to some tentative steps toward formulating a political strategy for Southeast Asia.

The first indication of this came during Prime Minister Suzuki's January 1981 tour through the region when he said that Japan should "play a political role to help maintain world peace . . . a role commensurate with Japan's status in the community of nations."[4] Just what Tokyo's role should be remained unclear -- as it largely does today. On certain issues, such as the Cambodian problem, Japan's political cooperation with ASEAN has been quite forthcoming. If there is one tie that binds the six member nations, it is their opposition to Vietnam's presence in Cambodia. Tokyo has been a strong supporter of ASEAN's concerns in this area, not only verbally but also by suspending aid to Vietnam after the 1979 invasion of Cambodia.

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[4] Eiichi Imagawa, "Development of Japan's Political Roles in Southeast Asia -- Japanese Policy Toward Southeast Asia," in Gaston Sigur and Young C. Kim (eds.), Japanese and U.S. Policy in Asia (New York: Praeger Publishers, 1982), p. 134.

Moreover, the extent of Japan's official development assistance to Thailand not only reflects the country's economic needs, but Japan's support of ASEAN's position on the Cambodian issue. In 1980 Tokyo adopted "comprehensive national security" -- that is, the consideration of military and non-military factors in security issues -- as national policy. Under this policy Prime Minister Masayoshi Ohira decided that Thailand was one of three countries to fit the category "countries bordering conflict areas." Consequently, aid was increased in recognition of its "front line" status in the conflict with Vietnam.

If Tokyo's cooperation on this issue is welcomed, its increasing military presence in the area meets with much more hesitation. Thus, ASEAN countries greeted Tokyo's December 1986 decision to abandon the 1 percent of GNP defense spending cap with deep suspicion. Many analysts explain this reaction by pointing to ASEAN's bitter memories of Japan's wartime campaign to establish a "Greater East Asia Co-Prosperity Sphere." Still, this is probably only part of the story. ASEAN's concerns are probably also an outgrowth of Japan's expanding economic presence. Members fear that allowing Japan to acquire political and military influence as well as economic power would pose a risk to their national identities.

Moreover, the fear of Japan's rearmament almost certainly reflects more than an aversion to Japanese domination. A greater Japanese military presence could encourage the United States to withdraw from the region, leaving its defense to Tokyo. This is, of course, less than optimal for the ASEAN members, which have made no secret of their desire to see the United States maintain its military position in the region.

Another political sticking point is China. Since reestablishing diplomatic ties with Beijing in 1978, Tokyo has had to perform a regional balancing act. Not only do some ASEAN countries -- especially Indonesia -- consider China a security threat, on its own and through its support of communist insurgency movements, but all believe that Japan's relationship with China could threaten their economic interests. In recent years they have witnessed a substantial increase in the volume of aid and investments flowing to China as well as a hike in Japan's imports from that country.

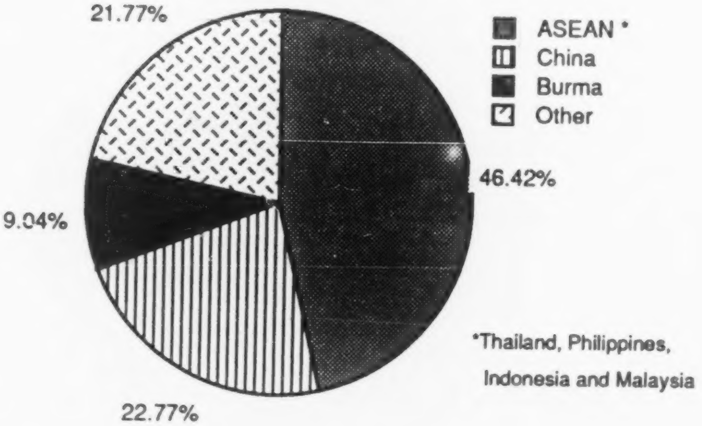
Tokyo has emphasized that there is no cause for worry. With regard to aid flows, officials state unequivocally: "Economic cooperation with China will not be given to the detriment of its cooperative relations with other developing countries, in particular the ASEAN countries."[5] Despite these assurances, China has been the number-one recipient of Japan's assistance since 1981 -- a position previously held by ASEAN members.

[5] Ministry of Foreign Affairs, Japan's ODA 1985, p. 14.

Japan's Aid to ASEAN

Doubts about China notwithstanding, economic assistance is probably the area that has provoked the least dissension. Not surprisingly, then, it is the subject with which Tokyo is most confident. Japan's entire development assistance program emphasizes Asia -- specifically the ASEAN countries, China and Burma (see Figure 6). Since the late 1970s, a 7-1-1-1 formula has been in effect: roughly 70 percent of development aid is slated for Asia, while Latin America, Africa and the Middle East receive approximately 10 percent each. Although this formula has been slightly relaxed in recent years -- roughly two-thirds of Japan's official development assistance reaches Asia -- Japan continues to emphasize the regional element of its aid program.

Figure 6: ASEAN's Share of Japan's ODA To Top Ten Aid Recipients, 1985



*Thailand, Philippines, Indonesia and Malaysia

Of course, ODA figures do not include Japan's multilateral aid nor the activities of private organizations. Japan is the largest contributor to the Asian Development Bank, as well as a major donor to the Asian Productivity Organization and the Southeast Asia Fisheries Development Center. Further, over 200 non-governmental aid organizations exist in Japan. One of the best known, the Japan International Volunteer Center, sends more than 1,000 volunteers abroad, especially to Southeast Asia. Another is the Asian Community Trust, which offers financial assistance for development projects.

The United States has endorsed Tokyo's aid efforts in Asia and has asked Japan to expand its assistance to the region. A recent Japanese news article likened the idea to the Marshall Plan, noting that the goal of the proposal is to enhance political and economic stability in the region.[6]

[6] Nihon Keizai Shimbun, October 21, 1986.

Conclusion

Despite the close relations that Japan enjoys with ASEAN countries, inherent tensions exist. Japan must formulate policies with global considerations in mind, while the major issues facing ASEAN members are regional. This has prompted complaints on occasion that Tokyo is neglecting their requests while courting the goodwill of its industrialized partners. Moreover, although ASEAN members hope for Japan's cooperation in furthering their development goals, they are adamantly opposed to Japanese economic or political domination. Tokyo is well aware that a recurrence of the 1974 anti-Japan demonstrations is possible if its economic presence begins to incur resentment among members.

Nonetheless, the relationship is secure. Both sides recognize the value of maintaining harmonious ties, as well as the vital role each plays for the other's political and economic security. In this respect, they have already established Mr. Abe's idea of a "creative partnership." By contrast, the quest for "heart-to-heart relations" has not ended.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Behind The Scenes With The Trade Bill

Although the House committee markup of the trade bill (HR 3) has finished, the shape of the legislation is still a question mark because of a jurisdictional battle between the Ways and Means and Energy and Commerce Committees. Intense behind-the-scenes negotiations are being conducted before the bill reaches the Rules Committee in an attempt to resolve most of the tough compromises before the floor debate.

- The requisite five years of experience practicing "home" law may be accumulated anywhere other than Japan (see next point). The time an American lawyer spends practicing U.S. law in Europe, for example, could count toward the five-year requirement. Experience gained as a federal government attorney counts regardless of location.

- Up to two years of experience as a legal trainee in Japan applies toward the five-year requirement for those in Japan when the law takes effect.

- There is no limit on the number of clerks and assistants each qualified foreign lawyer may bring to Japan, as long as the "necessity and nonreplacability of their services" can be demonstrated.

- The Ministry of Justice will grant the necessary statement of qualifications to foreign applicants within three months of application. The foreign lawyer must also register with the Japan Federation of Bar Associations (Nichibenren). Nichibenren has also pledged to process registration applications within three months.

- Business associations between foreign and Japanese lawyers (_bengoshi_) are permitted by the ministry. The only limits are prohibitions on profit sharing and on the hiring of a _bengoshi_ by a foreign lawyer. Note that in the latter case, the opposite is permitted: a Japanese lawyer is free to hire a foreign lawyer. Therefore, offices, support staff and expenses may be freely shared and clients may be referred between foreign and Japanese lawyers.

While some points are still being clarified, such as rules governing advertising, officials hope that the agreement will satisfy the lawyers and their clients. The agreement has prompted Texas to begin the process of changing its state regulations to meet the reciprocity requirements, and drawn similar interest from the State of Washington and other jurisdictions. Although the agreement has met with mixed reviews, and some suspicion about MOJ's implementation remains, only time will show if this case has been closed.

Jon Choy

JNR Privatization Arrives On Time

On April 1 Japanese National Railways, the last major government-owned corporation, was split into six private passenger rail lines, one freight company, three non-rail firms and one holding company. The change, which marked the end of an era of government involvement in basic services, underscored Tokyo's commitment to deregulation. No matter how drastic the restructuring, however, the burden of JNR's Y37.7 trillion ($251.3 billion at Y150=$1.00) debt remains a major problem.

JNR was created June 1, 1949 by combining the various government-owned railways under the supervision of the Ministry of Transport. Growth was fueled by reconstruction efforts during the first two decades and by ambitious expansion plans during the 1970s. JNR's assets were tremendous: 200 rail lines with more than 13,000 miles of track; 45,500 rail cars; 5,000 stations; 226 square miles of land; and investments worth Y41.5 billion ($276.7 million) in 155 non-rail enterprises; but so were its debts. JNR suffered a record operating loss of Y2,020.1 billion ($13.5 billion) in fiscal 1985, 11 percent more than the previous year. JNR management attributed the deterioration to higher outlays for retirement benefits and interest payments. Although profits from other areas rose 2 percent to Y191.9 billion ($1.3 billion), it was not nearly enough to prevent a record net loss of almost Y1,845 billion ($12.3 billion). This left the giant company in the red to the tune of Y14.1 trillion ($94 billion) in short-term debt and Y23.6 trillion ($157.3 billion) in long-term obligations.

The new Japan Railways group of passenger lines will employ 215,000 of JNR's 276,000 employees; the remaining 61,000 have taken early retirement or received job offers from other firms (see Table). The holding company, JNR Liquidation Corp., will offer job placement services to 7,800 regional workers displaced by the privatization, and work at disposing most of JNR's Y37.7 trillion ($251.3 billion) debt. A total of Y14.6 trillion ($97.3 billion) will be shouldered by the new freight line, the bullet train and the three most profitable passenger service companies. JNR Liquidation hopes to redeem another Y8.4 trillion ($56 billion) by selling 12.9 square miles of JNR land and shares of stock in the new companies. The remaining Y14.7 trillion ($98 billion) will be refinanced and redeemed over the next 30 years.

Employment Plans of the Japan Railway Group

	Ex-JNR employees	Vacancies	Total
Hokkaido Railway Co., Ltd.	12,719	281	13,000
Eastern Japan Railway Co., Ltd.	82,472	7,068	89,540
Central Railway Co., Ltd.	21,410	3,790	25,200
Western Japan Railway Co., Ltd.	51,543	1,857	53,400
Shikoku Railway Co., Ltd.	4,465	435	4,900
Kyushu Railway Co., Ltd.	14,589	411	15,000
Japan Freight Railway Co., Ltd.	12,009	491	12,500
Shinkansen Property Corp.	58	2	60
Railway Telecommunications Co., Ltd.	563	7	570
Railway Information Systems Co., Ltd.	275	5	280
Railway Technical Research Institute	545	5	550
Total	200,648	14,352	215,000

Source: Nihon Keizai Shimbun

Officials hope that each of the companies will break even in the first year of operation, although the three passenger rail units serving sparsely populated regions will receive a modest government subsidy. The prescribed remedy, which calls for higher fares and reduced service, will disadvantage rural areas highly dependent on JNR service, as the metropolitan areas are already served by several private lines. Freedom from bureaucratic control is also key; not only will innovation and new services be promoted, but basic areas such as food service and employee courtesy will be stressed. Diversification into such areas as travel services and convenience stores form important parts of the group's plans.

The privatization will complete a wrenching overhaul of the railway unions. The Japan Railway Workers' Union (Tetsuro) and the National Railway

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FOREIGN DIRECT INVESTMENT IN JAPAN: 1987 UPDATE

Summary

Although foreign direct investment in Japan fell in 1986, important trends emerged. Financial institutions pumped significant amounts of money into new or existing operations to take advantage of Tokyo's financial liberalizations. Research and development-related investments showed a slight decline in total value, more a reflection of the depressed state of high technology markets than a lessened interest in the quality of research in Japan. Finally, medium-sized firms initiated more adventurous and independent business plans that often required investments in local production, design or marketing facilities. This analysis will report on these trends as well as provide an overall view of foreign direct investment in Japan.

The Investment Environment

In 1986 foreigners deciding whether to invest in Japan were buffeted by conflicting signals that resulted from economic, social and regulatory developments rather than changes in the legal framework governing investment. The most obvious dampening factor was the yen's upward spiral against the dollar, which raised the cost of dollar-denominated investments 26 percent over the course of the year. Given the time lag between deciding to invest and actually paying the bills, the exchange rate looms even larger: decisions based on 1985 rates cost an average of 42 percent more to implement in 1986. The increased cost was enough to discourage the casual investor and give pause to the serious.

Balancing the yen's appreciation, Tokyo's deregulation program provided significant incentives for foreigners to invest in several important areas, including telecommunications, financial services and tobacco products. Large foreign companies, particularly American ones, made significant investments in telecommunications, both before and in response to the April 1, 1985 deregulation of the domestic market. In 1986 a second investment wave of smaller companies judged that the booming market for terminal equipment and value-added services justified the risk.

The arrival of foreign firms on the floor of the Tokyo Stock Exchange and the opening of the trust banking market to competition from abroad led to a major increase in foreign investment in these areas. Foreign financial institutions also began to lay the foundations for a larger presence in other fields, including the primary and secondary market for Japanese government bonds, foreign exchange transactions and offshore banking. There was increased interest in other financial services, such as insurance, real estate and personal credit as well. Finally, foreign tobacco products manufacturers continued to push ahead with plans to compete with the ex-public monopoly Japan Tobacco Inc. for a share of the Japanese market. Investments in distribution networks rose as overseas firms worked to establish sales channels independent of JTI. The opportunities created by deregulation are a siren song for foreign companies.

Finding local skilled production and managerial personnel has been a major obstacle to the success of previous foreign ventures in Japan. The lifetime employment system and strong company loyalty made it difficult for foreign companies to attract qualified workers. But slower domestic growth coupled with increasing international competition and reduced profits caused by a stronger yen have forced many Japanese companies to re-evaluate their employment policies. Early retirement plans, part-time work and layoffs have been announced, even at major Japanese corporations, creating a new pool of highly experienced unemployed workers. In addition, younger Japanese, disenchanted with the prospect of slow but steady advancement up the corporate ladder, have a more flexible attitude toward job-hopping and executive placement firms. The old social taboo against changing jobs in mid-career still exists, but cracks in this mentality are growing larger as Japan adjusts its economic structure.

The availability of land can be a problem in Japan. Office space in major metropolitan areas, particularly Tokyo, has always been at a premium. The expansion or establishment of offices by major foreign financial and commercial companies only worsened the situation. Investors faced the same conditions in attempting to put up a factory or warehouse near the major urban centers. Japan's Technopolis regional development plan, however, offered some relief to companies willing to locate in the countryside. Work on the 14 designated Technopolis locations is well underway, but foreign firms can still take advantage of the array of special tax provisions and low-cost financing plans if they join the development.

Financial deregulation has not only created new investment opportunities but has made funding investments easier. The increased competition among domestic and foreign financial institutions as well as the explosion of financial

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instruments has given foreign investors unprecedented flexibility to meet financing needs.

While foreign investment decisions are never a simple matter, entrepreneurs interested in Japan were faced with both more problems and more opportunities. From a long-term point of view, 1986 must be counted as a positive year for foreign investors. While the yen is likely to retain its stronger position, the impact of this one-time adjustment will fade, while the process of economic and social change, as demonstrated by deregulation and labor market changes, presents a strategic opportunity for foreign investors.

Overview of the Record for 1986

According to figures compiled by the Japan Economic Institute, major direct investments (defined by MOF as greater than Y100,000 or $667 at Y150=$1.00) recorded a strong gain of 79.7 percent in value terms in 1986, reaching Y199.4 billion ($1.3 billion), while the number of cases rose just 0.8 percent to 839. (According to notifications registered with the Ministry of Finance, however, last year's 2,915 foreign direct investments totaled $728 million, a decline of 575 cases (16.5 percent) and $42 million (5.5 percent) from 1985's record total.) It is important to note two major caveats about the data. First, there is no verification of investments by MOF officials. Given the tortuous negotiations that precede an investment, it would not be surprising to find that many prospective deals ultimately fell through. Second, the notifications are submitted in Japanese and translated into English by the ministry. We have made no effort to verify the names, value or current status of these investments. Thus the information should be construed only as an indication of trends.

An analysis of major investments by country shows continued U.S. dominance (see Tables 1 and 2). The U.S. share of the total rose to an impressive 71.3 percent of the value and 36.7 percent of the cases in 1986, easily outdistancing Britain (second place), West Germany (third) and Hong Kong (fourth). Investment from China increased significantly, mainly due to the establishment of general trading companies. Funds from Indonesia, Singapore, Thailand and Malaysia showed a sharp 56 percent drop, possibly due to the rise of the yen.

The most interesting development, however, was the jump in investments from overseas Japanese subsidiaries. (These appear in MOF statistics presumably because they are direct investments rather than repatriated profits.) Whereas it was not significant enough to be broken out of the "Other Asia" category in 1985, it reached the surprising level of nearly Y10 billion ($67 million) last year, which would have put it in third place if it were considered a foreign country. Nippondenso America Inc., for example, put Y2,340 million ($15.6 million) into Asmo Co., Ltd., a Japanese automotive parts producer. In another case, Mitsui & Co. (USA) Inc. invested Y292.5 million ($1.9 million) in a Japanese restaurant management venture, EIM Services Co., Ltd. The reason for the sudden jump is unclear -- there may be tax advantages in this approach.

The expansion of existing holdings continued to play an increasingly important role, accounting for 71 percent of the value of all major investments, compared with 62 percent in 1985 and 25 percent in 1984. In terms of the number of investments, however, its share has fallen from 25.8 percent in 1984 to just 18.5 percent in 1986. There was renewed interest in the establishment of new firms, which accounted for 53.3 percent of all major cases, up from 45.9 percent the previous year. Demand for a new stake in an existing firm was flat in 1986, resulting in slight declines in both value and cases.

Investments by individuals and foreign-owned or overseas Japanese subsidiaries represented a declining share of total major investments (0.7 percent versus 1.3 percent and 9 percent versus 19.6 percent, respectively), mainly due to surging outlays by parent corporations. Since investment by overseas Japanese subsidiaries was up, outlays by foreign subsidiaries in Japan must have declined drastically.

Overall, some interesting trends emerge. Businesses, particularly American firms, spent a surprisingly large amount strengthening existing operations, perhaps indicating an increased long-term commitment to the Japanese market. The surge in new ventures also suggests that planners are optimistic about the Japanese market's potential. Finally, the United States overwhelmingly dominated Japan's foreign direct investment picture in 1986, making its leadership position nearly unassailable.

Emerging Trends

An analysis of investment patterns by industry underscores enduring themes as well as some important new trends (see Table 3). Investment in commerce (wholesale and retail trade) remains dominant in terms of value, with manufacturing holding on to second place. Within the manufacturing sector, chemicals and related products continue to garner the largest share of investments (in large part due to investments in pharmaceutical and biotechnology-related ventures), followed by transportation equipment (mostly linked to the automotive industry), electric machinery and electronics (primarily computers and integrated circuits), and precision, medical and photographic equipment.

Financial firms, as previously mentioned, made a big splash on the Japanese investment scene; the six banking-related cases reported a total value of Y16 billion ($107 million). This is almost certainly just the start as financial deregulation proceeds and financial markets become a part of the international network. (The advent of 24-hour stock trading will be the next major step.) With foreign banks and securities firms reporting good profits, second-tier and related service firms are considering investing in Japan. In addition, companies that offer personal financial services, such as credit, loans and fund management, are attracted to the Japanese market by the high level of personal savings and the changing tastes of consumers.

A wave of smaller firms is breaking on Japanese shores, following the path of large companies such as International Business Machines Corp. and E.I. duPont de Nemours & Co. Some of the smaller companies have been exporting to Japan for some time using Japanese trading companies or other partners as their agents. Now, however, these firms are interested in expanding sales through local production, design and marketing, a strategy that requires establishing wholly owned subsidiaries. This is most apparent in the electronics and automotive parts industries. Suppliers of electronic components, such as resistors, disk drive heads and power supplies, view responsiveness to customer needs as the key to success -- a key that can only be forged by a strong local presence.

In other cases, the situation mirrors Japanese direct investments in this country: smaller suppliers follow investing firms overseas in order to maintain traditional relationships with companies building American production facilities and, incidentally, to gain a foothold in new markets.

Tokyo's market deregulations have opened niches that small firms can quickly fill. This is particularly true for value-added telecommunications services. American experience with local area networks, value-added networks, distributed data processing and point-of-sale systems is being put to use in Japan. Small U.S. firms offer specialized turnkey systems in a wide range of areas, including inventory control, accounting, small business and professional operations. Although they face very stiff competition from Japan's growing software and personal computer industry, many have decided to take the plunge.

After making a strong showing in 1985 -- 24 cases worth Y845.5 million ($5.63 million) -- investments related to research and development showed mixed results in 1986. As shown in Table 4, the number of cases rose to 29 but the total value dropped to Y541.7 million ($3.4 million). Chemicals and related products were the favorites in terms of research subjects, in contrast to 1985 when computer and electronic equipment accounted for one-third of the total. The United States continued to rank at the top in terms of value and number of investments, although declines were recorded in both categories. The drop as well as the absence of other countries investing in this field probably reflect the stronger yen and depressed global computer industry; large companies with deep pockets accounted for all 1986 investments. In some cases, R&D investments may not appear in the figures, as when funds are put into a pharmaceutical firm, for example. Research is almost certainly done by the venture, but it falls into a different statistical category. The decline can be expected to be temporary -- the quality of research performed in Japan is considered excellent.

Conclusion

Patterns of foreign direct investment in Japan in 1986 reveal how complicated the decision can be. While the stronger yen argued against investing, deregulation and other factors attracted investors' interests. The mixture of gains and losses also shows that the Japanese economy is in the process of major adjustments. With no legal barriers to hinder them, foreign investors are presented with opportunities and pitfalls in the Japanese market.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Major Direct Foreign Investments in Japan by Country and Category, 1985*

(in millions of yen; share of total in parentheses)

Investor	Total		New Firms		Existing Firms		Expanded Holdings	
	Value	Cases	Value	Cases	Value	Cases	Value	Cases
United States	Y59,657.7 (53.8%)	288 (34.6%)	Y11,848.6 (52.7%)	175 (45.8%)	Y9,709.3 (50.0%)	57 (23.5%)	Y38,099.84 (55.2%)	56 (27.1%)
Canada, Central & South America	4,551.9 (4.1)	62 (7.5)	1,223.9 (5.4)	14 (3.7)	1,558.4 (8.0)	30 (12.3)	1,769.6 (2.6)	18 (8.7)
United Kingdom	11,226.2 (10.1)	80 (9.6)	1,905.8 (8.5)	29 (7.6)	2,084.2 (10.7)	41 (16.9)	7,236.2 (10.5)	30 (14.5)
West Germany	1,883.1 (1.7)	38 (4.6)	1,411.5 (6.3)	22 (5.6)	117.5 (0.6)	10 (4.1)	354.1 (0.5)	6 (2.9)
France	2,856.2 (2.6)	60 (7.2)	437.8 (1.9)	25 (6.5)	1,655.4 (8.5)	21 (8.6)	763.0 (1.1)	14 (6.8)
Other Europe	17,584.3 (15.9)	125 (15.0)	3,623.3 (16.1)	43 (11.3)	1,690.1 (8.7)	40 (16.5)	12,270.9 (17.8)	42 (20.2)
Hong Kong	10,553.7 (9.5)	51 (6.1)	585.3 (2.6)	18 (4.7)	2,134.5 (11.0)	14 (5.8)	7,833.9 (11.3)	19 (9.2)
Taiwan	442.9 (0.4)	29 (3.5)	295.2 (1.3)	17 (4.5)	95.6 (0.5)	5 (2.1)	52.1 (0.1)	7 (3.4)
Korea	73.0 (**)	5 (0.6)	60.0 (0.3)	4 (0.3)	13.0 (0.1)	4 (1.6)	0 (0.0)	0 (0.0)
Southeast Asia	393.8 (0.3)	19 (2.2)	292.4 (1.3)	9 (2.4)	76.2 (0.4)	8 (3.3)	25.2 (**)	2 (1.0)
Other Asia	1,220.2 (1.1)	45 (5.4)	535.5 (2.4)	23 (6.0)	38.9 (0.2)	10 (4.1)	645.8 (0.9)	12 (5.8)
Africa	0.2 (**)	1 (0.1)	0 (0.0)	0 (0.0)	0 (0.0)	0 (0.0)	0.2 (**)	1 (0.5)
Middle East	483.3 (0.4)	9 (1.1)	250.8 (1.1)	6 (1.6)	232.5 (1.2)	3 (1.2)	0 (0.0)	0 (0.0)
Total	110,926.5	832	22,470.1	382	19,405.6	243	69,050.8	207
of which:								
Individuals	1,463.5 (1.3)	120 (14.4)	737.0 (0.3)	62 (16.2)	216.5 (1.1)	40 (16.5)	510.0 (0.1)	18 (8.7)
Subsidiaries	21,742.9 (19.6)	112 (13.5)	2,316.3 (10.3)	52 (13.6)	3,421.2 (17.6)	32 (13.2)	16,005.4 (23.2)	28 (13.5)

* Stock purchases with a value greater than Y100,000.
** Less than 0.1 percent.

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.

Table 2: Major Direct Foreign Investments in Japan by Country and Category, 1986*

(in millions of yen; share of total in parentheses)

Investor	Total		New Firms		Existing Firms		Expanded Holdings	
	Value	Cases	Value	Cases	Value	Cases	Value	Cases
United States	Y142,136.4 (71.3%)	308 (36.7%)	Y20,510.6 (50.4%)	178 (40.4%)	Y2,537.7 (15.0%)	81 (34.3%)	Y119,088.1 (84.0%)	49 (31.6%)
Canada, Central & South America	3,493.3 (1.8)	59 (7.0)	1,610.1 (4.0)	37 (8.4)	1,101.4 (6.5)	15 (6.4)	781.8 (0.6)	7 (4.5)
European Community	26,370.2 (13.2)	274 (32.7)	7,964.2 (19.6)	134 (30.4)	7,357.2 (43.4)	75 (31.8)	11,048.8 (7.8)	65 (41.9)
United Kingdom	15,765.5 (7.9)	101 (12.0)	3,871.5 (9.5)	38 (8.6)	4,725.3 (27.9)	36 (15.3)	7,168.7 (5.1)	27 (17.4)
West Germany	3,978.3 (2.0)	53 (6.3)	2,067.4 (5.1)	29 (6.6)	1,322.2 (7.8)	16 (6.8)	588.7 (0.4)	8 (5.2)
France	3,323.6 (1.7)	57 (6.8)	621.8 (1.5)	28 (6.3)	419.0 (2.5)	11 (4.7)	2,282.8 (1.6)	18 (11.6)
Other Europe	15,567.4 (7.8)	47 (5.6)	9,433.2 (23.2)	25 (5.7)	385.2 (2.3)	14 (5.9)	5,749.0 (4.1)	8 (5.2)
Hong Kong	3,497.4 (1.8)	39 (4.6)	718.8 (1.8)	15 (3.4)	101.8 (0.6)	9 (3.8)	2,676.8 (1.9)	15 (9.7)
Taiwan	313.1 (0.2)	23 (2.7)	278.1 (0.7)	14 (3.2)	34.4 (0.2)	8 (3.4)	0.6 (**)	1 (0.6)
Korea	111.9 (**)	6 (0.7)	34.8 (0.1)	2 (0.5)	77.1 (0.5)	4 (1.7)	0 (0.0)	0 (0.0)
Southeast Asia	171.9 (0.1)	11 (1.3)	52.4 (0.1)	3 (0.7)	119.5 (0.7)	8 (3.4)	0 (0.0)	0 (0.0)
China	374.1 (0.2)	13 (1.5)	253.6 (0.6)	8 (1.8)	120.5 (0.7)	5 (2.1)	0 (0.0)	0 (0.0)
Japan	9,594.5 (4.8)	56 (6.7)	654.2 (1.6)	26 (5.9)	5,795.2 (34.2)	16 (6.8)	3,145.1 (2.2)	14 (9.0)
Other Asia	68.7 (**)	16 (1.9)	48.4 (0.1)	12 (2.7)	8.3 (**)	1 (0.4)	11.0 (**)	2 (1.3)
Africa	43.5 (**)	3 (0.4)	43.0 (0.1)	2 (0.5)	0.5 (**)	1 (0.4)	0 (0.0)	0 (0.0)
Middle East	96.7 (**)	7 (0.8)	62.0 (0.2)	5 (1.1)	34.7 (0.2)	2 (0.8)	0 (0.0)	0 (0.0)
Total	199,375.5	839	40,693.0	448	16,958.3	236	141,724.2	155
of which:								
Individuals	1,452.4 (0.7)	96 (11.4)	635.6 (1.6)	67 (15.2)	157.6 (0.9)	22 (9.3)	659.2 (0.5)	7 (4.5)
Subsidiaries	17,857.2 (9.0)	190 (22.6)	5,076.6 (12.5)	88 (20.0)	7,874.6 (46.4)	58 (24.6)	4,906.0 (3.5)	44 (28.4)

* Stock purchases with a value greater than Y100,000.
** Less than 0.1 percent.

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.

Table 3: Major Foreign Direct Investment in Japan by Industry, 1986

(in millions of yen and share of total)

Industry and SIC Number	Value		Cases	
Agriculture, forestry and fishing (01-09)	Y154.3	0.1%	3	0.4%
01 Agricultural production - crops	10.0	*	1	0.1
08 Forestry	6.5	*	1	0.1
09 Fishing, hunting and trapping	137.8	0.1	1	0.1
Mining (10-14)	1,744.9	8.8	9	1.1
13 Oil and gas extraction	1,744.9	8.8	9	1.1
Construction (15-17)	336.5	0.2	7	0.8
15 Building construction	310.0	0.2	2	0.2
16 Other construction	16.5	*	4	0.5
17 Construction - special trades	10.0	*	1	0.1
Manufacturing (20-39)	53,102.6	26.6	286	34.1
20 Food and kindred products	345.7	0.2	24	2.9
22 Textile mill products	163.2	0.1	2	0.2
23 Apparel	286.4	0.1	10	1.2
24 Lumber and wood products	50.0	*	1	0.1
25 Furniture and fixtures	4.8	*	1	0.1
26 Paper and paper products	108.5	0.1	3	0.4
27 Printing and publishing	73.0	*	4	0.5
28 Chemicals and related products	17,502.1	8.8	47	5.6
30 Rubber and miscellaneous plastic products	709.0	0.4	11	1.3
32 Stone, clay, glass and concrete products	5,030.6	2.5	10	1.2
33 Primary metals	412.1	0.2	7	0.8
34 Fabricated metal products	506.2	0.3	13	1.5
35 Nonelectric machinery	3,373.4	1.7	64	7.6
36 Electric machinery and electronics	8,447.9	4.2	54	6.4
37 Transportation equipment	8,476.7	4.3	14	1.7
38 Precision, medical and photographic equipment	5,488.9	2.8	15	1.8
39 Miscellaneous manufactures	2,124.1	1.1	6	0.7
Transportation, communications, electric, gas, and sanitary services (40-49)	1,657.7	0.8	37	4.4
42 Motor freight transportation and warehousing	64.0	*	4	0.5
44 Water transportation	166.3	0.1	13	1.5
45 Air transportation	52.0	*	7	0.8
47 Transportation services	318.8	0.2	8	1.0
48 Communications	1,056.6	0.5	5	0.6
Wholesale trade (50-51)	Y118,275.8	59.3%	271	32.3%
50 Durable goods	112,753.2	56.6	161	19.2
51 Nondurable goods	5,522.6	2.8	110	13.1
Retail trade (52-59)	1,130.5	0.6	19	2.3
52 Building materials, hardware, garden supply and mobile home dealers	3.0	*	1	0.1
53 General merchandise stores	31.8	*	1	0.1
55 Automotive dealers and gasoline service stations	430.7	0.2	7	0.8
58 Eating and drinking places	665.0	0.3	10	1.2
Finance, insurance and real estate (60-67)	18,909.7	9.5	51	6.1
60 Banking	16,000.0	8.0	6	0.7
61 Credit agencies	1,161.7	0.6	5	0.6
62 Security and commodity brokers, dealers, exchanges and services	76.7	*	1	0.1
63 Insurance	505.0	0.3	2	0.2
65 Real estate	350.3	0.2	13	1.5
67 Holding and other investment offices	816.0	0.4	24	2.9
Services (70-89)	4,063.5	2.0	156	18.6
70 Hotels, camps and other lodgings	717.6	0.4	4	0.5
72 Personal services	251.0	0.1	11	1.3
73 Business services	2,791.6	1.4	108	12.9
78 Motion pictures	71.1	*	10	1.2
79 Amusement and recreation services	81.8	*	9	1.1
81 Legal services	3.0	*	1	0.1
82 Educational services	15.9	*	2	0.2
84 Museums, art galleries, botanical and zoological gardens	0.5	*	1	0.1
89 Miscellaneous services	131.0	0.1	10	1.2
Total	199,375.5	100.0	839	100.0

*Less than 0.1 percent.

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.

Table 4: Foreign Direct Investment in Research and Development, 1985-86

(in millions of yen and number of cases)

a. By Industry

SIC Category	Value	Cases
1985		
Food storage (20)	¥3.0	1
Pharmaceuticals (2834)	50.0	1
Polymer resins (3070)	180.0	1
Construction equipment (3531)	1.3	1
Printing/binding machinery (3555)*	150.0	1
Special trade machinery (3559)	15.5	1
Computers and peripheral equipment (3573)**	232.5	8
Electric and electronic machinery (36)	10.0	1
Integrated circuits (3674)	20.0	1
Automotive parts (3714)	51.1	1
Measuring and checking equipment (3823)	—	—
Medical equipment (3841)	48.0	1
Dental materials (3843)	0.5	2
Software (7372)	86.6	4
Total	845.5	24

*Investment also related to 3823
**Includes one investment related to 3573 and 7372

SIC Category	Value	Cases
1986		
Seeds (0791)	¥2.6	1
Chemicals (28)	180.0	1
Industrial gases (2813)	50.0	1
Protein engineering (2830)	35.2	3
Pharmaceuticals (2834)*	4.0	1
Agricultural chemicals (2870)	50.0	1
High-polymer membranes (3079)	12.0	1
Rare metals (3339)	125.0	1
Food products machinery (3551)	0.8	2
Computers and peripheral equipment (3573)	9.5	3
Communications equipment (3660)	36.9	9
Electronic parts (3670)	8.8	1
Medical supplies (3840)	—	—
Software (7372)	11.9	3
Container technology (3221/3411)	15.0	1
Total	541.7	29

*Investment also related to 3840

b. By Country

Country	Value	Cases
1985		
United States	¥174.5	8
France	228.0	4
United Kingdom	256.9	3
Luxembourg	51.0	3
West Germany	51.0	1
Italy	1.0	1
Netherlands	30.8	1
Canada	3.0	1
Hong Kong	48.0	1
Japan	1.3	1
Total	845.5	23
1986		
United States	¥81.9	18
France	225.0	3
United Kingdom	25.9	3
West Germany	4.0	1
Switzerland	9.0	1
Lichtenstein	180.0	1
Hong Kong	15.0	1
Japan	0.9	1
Total	541.7	29

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.

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U.S.-JAPAN COMPETITION IN SEMICONDUCTORS: AMERICAN MAKERS RETHINK STRATEGIES

Summary

Silicon Valley executives have warned since the late 1970s that the United States risked losing world leadership in the critical semiconductor field to Japan unless Washington helped reverse the odds (see JEI Report No. 30A, August 12, 1983). Experts now say the question no longer is which country's industry will be the technological and market leader; instead, it is whether American manufacturers of semiconductors for outside sale will survive and how. Merchant manufacturers and industry analysts have mapped out a long list of survival strategies, but one of the few points of agreement is that U.S. suppliers must expand their limited sales in Japan using last year's trade pact as the springboard. Most controversial is the move by major merchant makers to form partnerships with their Japanese rivals in areas ranging from development work to production.

Changing Competitive Environment

Boom-and-bust business conditions have always been a fact of life for U.S. semiconductor manufacturers selling on the open market, but the battering the merchant industry has taken in the mid-1980s goes beyond the normal cyclical contraction. Thirty months after orders went on the skids, producers still see no signs that a strong upswing in demand for integrated circuits and discrete devices is in the works, either at home or abroad. By itself, the length of this dry spell sets the current slump apart from earlier ones. Yet both Silicon Valley executives and Reagan administration policymakers are convinced that the causes of the domestic industry's problems run far deeper than weak demand. They argue that fundamental changes have occurred in the world semiconductor market -- changes that threaten the continued existence of the major merchant makers as independents regardless of what happens to demand.

To no one's surprise, Japan's semiconductor companies are the villains in the scripts circulating around the merchant industry and Washington. For starters, Japanese makers, after steadily chipping away at the once-dominant world market share of U.S. suppliers, now control at least as much of the global business as their American competitors, according to leading American market research firms.

To make matters worse, say industry and government officials, Japanese competitors have decimated the ranks of domestic producers of DRAMs (dynamic random access memories) and wreaked havoc with the operations of U.S. suppliers of EPROMs (erasable programmable read-only memories). While commodity memory products account for only 15 percent or so of the semiconductor market, they have traditionally provided the profits to finance ever-increasing research and development costs and capital spending requirements in these and other semiconductor product lines. Moreover, the production processes mastered in turning out high-volume memory chips can be transferred to almost every device in a company's lineup. In short, analysts say, the forced retreat of merchant makers from commodity memories represents a double blow to the competitive position of the U.S. semiconductor industry.

American producers have also discovered that there are few havens from Japanese competition. In the early 1980s U.S. leadership in cutting-edge microprocessors and the peripheral chips used with them was believed to be immune to challenge; now, however, Japanese manufacturers are taking aim at this market. The same goes for bipolar logic circuits and other products like static RAMs. More recently, merchant producers that thought they had finally found shelter in the market for semicustom chips -- partially finished standard-design circuits that are tailored to each customer's needs -- have had another rude awakening: Japanese suppliers are also trying to occupy this niche.

Semiconductor Industry Association leaders and administration trade officials have a straightforward explanation for the success of Japan's assault on the world leadership role of American manufacturers, arguing that the structure of both its industry and its market gives Japanese challengers unfair advantages. Merchant makers' main Japanese competitors are huge, vertically integrated companies that generate a relatively small part of their revenues from sales of ICs and discrete devices. This structure, domestic critics charge, allows Japanese producers to sell commodity chips like DRAMs and EPROMs at prices that do not cover production costs. It also provides deep pockets to finance the development work and capital spending that are critical to continued international competitiveness. At the same time, industry and government representatives add, American semiconductor makers are unable to stake out anything more than a foothold in the Japanese market -- now estimated to rival the U.S. market in size -- because the biggest users of semiconductors are also the largest producers.

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The semiconductor trade agreement negotiators for the United States and Japan initialed July 30, 1986 after nine months of intense bargaining was an unprecedented attempt to address these twin U.S. complaints. The pact commits Tokyo to insure that Japanese suppliers price DRAMs and EPROMs at fair prices in both the United States and third markets and take steps to expand sales opportunities in Japan for foreign semiconductor producers (see JEI Report No. 28B, August 1, 1986). Administration officials are the first to acknowledge that these measures deal only with the symptoms of the problem. They argue, however, that if the agreement is fully implemented, it will go a long way toward neutralizing the structural advantages of Japanese semiconductor manufacturers.

Although questions of compliance have dogged the pricing part of the agreement almost from the start, the pact has brought belated price relief, particularly in the American market, to the two surviving merchant makers of DRAMs and to the larger group of domestic companies producing EPROMs. On the other hand, U.S. government and industry officials say they are still waiting for some evidence of the "steady" improvement in foreign access to the Japanese market that Tokyo promised.

Progress on this front has been slow. Yet Washington and Silicon Valley should have realized that the problems they had complained about for years would not disappear in nine months, even with Tokyo running interference. As Japanese officials have maintained all along, the government can promote a more open Japanese market but cannot guarantee increased U.S. sales in Japan. Responsibility for that development rests squarely with the private sector and -- as the American side concedes -- with U.S. semiconductor suppliers, which must demonstrate that they are committed to meeting the stiff requirements of Japanese buyers.

New Commitment to Japan

Merchant semiconductor manufacturers admit that their past performance in Japan makes it more difficult to win new business from demanding Japanese customers since in the all-important areas of price, quality, delivery and service, American suppliers have not always measured up to the local competition. But company spokesmen quickly add that the record of the last two years or so indicates a new U.S. commitment to the Japanese market. They point out that during a period of retrenchment in other parts of their operations, many of the 16 makers with Japanese sales subsidiaries (see Table 1) have expanded their marketing, support and/or quality-control staffs. Moreover, companies that have design centers have added engineers and technicians and in some cases installed new computer-aided engineering equipment, convinced that a strong in-country design capability is the key to expanded sales, particularly in the fast-growing Japanese market for ASICs (application-specific integrated circuits) or custom chips and semicustom devices like gate arrays and standard cells.

While labeling these moves steps in the right direction, Japanese market watchers insist that American semiconductor makers will never be more than marginal players in Japan unless they build manufacturing facilities there. Only four companies now have Japanese plants in operation (see Table 2) and just two have integrated facilities -- U.S. industry leader Texas Instruments

Inc., which ranks among the top 10 producers in Japan, and Motorola, Inc., the second-biggest American IC maker. Most of the other major merchant producers have considered establishing a Japanese production presence in recent years but have concluded that their current or near-term sales in Japan could not justify the $150 million or so it now costs to build a wafer fabrication plant there. Executives of a few of these companies have even questioned whether TI and Motorola are generating an adequate return on their Japanese investments since Texas Instruments Japan Ltd.'s 1985 semiconductor sales were $319 million (using a yearend exchange rate of Y200=$1.00) while Nippon Motorola Ltd.'s came to $32 million.

Proponents of a U.S. manufacturing presence in Japan reject this often-heard line of argument, saying that sales may never be large enough to justify a plant without building the plant first. One company that has decided to break this vicious circle is LSI Logic Corp. Later this year the Milpitas, California maker's Japanese subsidiary will open up a fabrication facility for silicon wafers and ASICs that is being financed in part by Kawasaki Steel Corp. Said the head of LSI Logic's local operation at the time the plant was announced, "This is the only way we can convince the Japanese user that we are serious" about serving the market.

Motorola is also making another effort to break the vicious circle. After announcing plans in July 1985 to build a second integrated production facility in Japan, Motorola unveiled a sweeping five-year agreement with Toshiba Corp. in late November 1986 that includes construction of an equally owned plant outside of Tokyo. Both companies will provide product technology for the factory, which is scheduled to come onstream in the first part of 1988. Japan's number-three semiconductor producer will contribute designs for the production of current and future generations of DRAMs and SRAMs, while Motorola will transfer designs for a broad line of microprocessors. But in a move widely applauded in the United States, Motorola has conditioned the transfer of its technology on increases in its semiconductor sales in Japan.

Several other merchant semiconductor manufacturers believe they have found ways to increase their Japanese market presence without investing in a plant. Under an open-ended 1985 agreement, for example, Zilog, Inc. is supplying the wafers for its 8-bit MPUs, 8-bit single-chip microcomputers and related peripheral chips to semiconductor maker Rohm Co., Ltd., which assembles and tests the products and then distributes them under its own name in Japan. Adopting a slightly different approach, National Semiconductor Corp. has what is known in the semiconductor business as a foundry agreement with NMB Semiconductor Co., Ltd. The five-year pact signed in September 1986 calls for National Semiconductor to provide the design technology for a line of SRAMs to be manufactured by the Japanese company, with marketing, both in Japan and elsewhere, handled by the U.S. firm. The first products are scheduled to be produced this summer.

Strategic Alliances

Partnerships of any kind are a major departure from the traditional go-it-alone strategies of merchant semiconductor manufacturers, but tying up with Japanese competitors represents a radical change in corporate philosophies. Many U.S. industry analysts believe, however, that selective alliances

Table 2: U.S. Merchant Semiconductor Manufacturers With Japanese Production Facilities

Company	Location	Year Opened	Processes	Products	Comments
Texas Instruments Inc.	Hatogaya, Saitama	1968	Wafer fabrication, assembly and test	MOS logic products	Roughly four-fifths of the products Texas Instruments makes in Japan are sold there.
	Hiji, Oita	1973	Wafer fabrication, assembly and test	Bipolar logic and memory products	
	Miho, Ibaraki	1979	Wafer fabrication, assembly and test	MOS memory products	
Motorola, Inc.	Aizu, Fukushima	1980	Wafer fabrication, assembly and test	Bipolar and MOS logic products	Initially a joint venture with Toko, Inc., Motorola bought out its partner in 1982. The plant's assembly capacity was recently increased 50 percent.
Analog Devices, Inc.	Shiroyama, Kanagawa	1982	Assembly and test	Linear: digital-to-analog and analog-to-digital converters and related circuits	Wafers imported from U.S. and U.K. plants. Factory assembles about half of the linear circuits Analog Devices sells in Japan.
Fairchild Semiconductor Corp.	Isahaya, Nagasaki	1984	Assembly and test	Bipolar and MOS logic products	Wafers imported from the United States. Completed but unopened wafer fabrication facility recently put up for sale.
LSI Logic Corp. Kawasaki Steel Corp.	Tsukuba, Ibaraki	1987*	Wafer fabrication	Silicon wafers; ASIC products	The plant's output will be shipped to other LSI facilities for assembly and testing and then will be marketed by the company in Japan, the United States and other markets. Kawasaki is a minority partner.
Motorola, Inc. Toshiba Corp.	Izumi, Miyagi	1988*	Wafer fabrication, assembly and test	MOS memory and logic products	Each of the partners in the equally owned venture will get half of the plant's output. The factory will initially make Toshiba's memory chips, later adding Motorola's microprocessors to the lineup.

*Planned

Table 1: U.S. Merchant Semiconductor Manufacturers With Japanese Sales Subsidiaries

Parent	Subsidiary	Year Opened	Main Semiconductor Product Lines	Design Center	
				Year Opened	Products
Texas Instruments Inc.	Texas Instruments Japan Ltd.	1968	MOS memory; MOS logic; bipolar logic; bipolar memory	*	*
Motorola, Inc.	Nippon Motorola Ltd.	1968	MOS logic; MOS memory; bipolar logic; bipolar memory	n.a.	n.a.
Analog Devices, Inc.	Analog Devices K.K.	1969	Linear circuits; hybrid circuits	1982	Linear circuits
Fairchild Semiconductor Corp.	Nippon Fairchild K.K.	1972	Bipolar logic; MOS logic	1985	Gate arrays
National Semiconductor Corp.	National Semiconductor Japan Ltd.	1972	Linear circuits; bipolar logic; MOS logic; microprocessors, microcontrollers and peripheral circuits	1980	Linear circuits
Advanced Micro Devices, Inc.	Advanced Micro Devices K.K.	1974	Linear circuits; bipolar logic; microprocessors and peripheral circuits	1987**	Semicustom products
Signetics Corp.	Signetics Japan Ltd.	1975	Linear circuits; bipolar logic; microprocessors, microcontrollers and peripheral circuits	1981	Linear circuits; microprocessors and microcontrollers
Intel Corp.	Intel Japan K.K.	1976	Microprocessors, microcontrollers, systems and boards; SRAMs; EPROMs	1980	MOS logic and memory products
Monolithic Memories, Inc.	Monolithic Memories K.K.	1976	Bipolar logic	--	--
Zilog, Inc.	Zilog Japan K.K.	1977	Microprocessors, microcontrollers and peripheral circuits	--	--
LSI Logic Corp.	LSI Logic K.K.	1984	MOS logic	1984	ASICs
Linear Technology Corp.	Linear Technology K.K.	1985	Linear circuits	--	--
International Rectifier Corp.	International Rectifier Far East Ltd.	1986	Field-effect transistors; solid-state relays	--	--
VLSI Technology Inc.	VLSI Technology K.K.	1986	ASIC products	1986	ASICs
Integrated Device Technology Inc.	Integrated Device Technology K.K.	1987	SRAMs; MOS specialty memories; microprocessors; MOS logic	--	--
Standard Microsystems Corp.	Toyo Microsystems Corp.	1987	ASIC products	1987**	Standard cell products

*Texas Instruments has design centers in Tokyo, Osaka and Miho, which were opened between 1969 and 1979. These centers do work for both in-house use and customer-related requirements.

**Planned

with Japanese producers are key to the future health of American semiconductor makers. Given the fast pace at which technology is advancing and the soaring costs of R&D and production, they argue, no American company can now afford to design and manufacture the range of devices it once did.

A few U.S. suppliers have adopted this approach. In February 1986, for example, Advanced Micro Devices Inc. and Sony Corp. agreed to work together on the development of process technologies. Seven months earlier LSI Logic and Toshiba signed a four-year pact covering the joint development of a new generation of gate arrays, with the Japanese company in charge of developing the production technology and LSI Logic responsible for the computer-aided design software. In the product supply area, Mitsubishi Electric Corp. is providing CMOS (complementary metal-oxide semiconductor) logic devices to Texas Instruments in exchange for transistor-transistor logic circuits under an agreement disclosed late last year.

Partnerships such as these and the Motorola-Toshiba agreement are still unusual. Already, though, a small but growing number of experts, including some in the government, are worried that tie-ups between American and Japanese semiconductor manufacturers will exacerbate the U.S. merchant industry's problems, not help resolve them, since in their view the Japanese partner is more likely to benefit from the arrangement. Domestic companies reject this argument, pointing to the Motorola-Toshiba pact as proof that U.S. producers can work out deals that will be mutually beneficial. In any case, they add, the possibility that a foreign alliance might backfire is one of the risks merchant semiconductor makers must take if they are to survive.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

APPENDIX

Table 1: U.S. Apparent Domestic Consumption of Semiconductors, 1982-86

(in thousands of dollars)

	1982	1983	1984	1985	1986
(including parts)					
Total Shipments	$10,728,702	$12,481,288	$17,395,417	$13,631,929	n.a.
Total Exports (f.a.s.)	3,797,368	4,361,466	5,334,635	4,239,177	4,869,694
Total Imports (Customs)	4,127,661	4,934,479	7,594,872	5,672,209	5,967,420
Trade Balance	-330,293	-573,013	-2,260,237	-1,433,032	-1,097,726
Apparent Domestic Consumption	11,058,995	13,054,301	19,655,654	15,064,961	n.a.
Exports as Percent of Apparent Domestic Consumption	34.3%	33.4%	27.1%	28.1%	n.a.
Imports as Percent of Apparent Domestic Consumption	37.3%	37.8%	38.6%	37.7%	n.a.
Exports to Japan (f.a.s.)	190,360	260,946	363,917	236,706	294,329
Imports from Japan (Customs)	583,607	917,739	1,978,397	1,316,893	1,381,669
Trade Balance	-393,247	-656,793	-1,614,480	-1,080,187	-1,087,340
Exports to Japan as Percent of Apparent Domestic Consumption	1.7%	2.0%	1.9%	1.6%	n.a.
Imports from Japan as Percent of Apparent Domestic Consumption	5.3%	7.0%	10.1%	8.7%	n.a.
(excluding parts)					
Total Shipments	8,994,616	10,652,364	15,653,076	12,097,769	n.a.
Total Exports (f.a.s.)	1,052,146	1,284,963	1,721,720	1,445,653	1,495,281
Total Imports (Customs)	3,895,147	4,521,789	6,698,332	4,865,536	5,088,993
Trade Balance	-2,843,001	-3,236,826	-4,976,612	-3,419,883	-3,593,712
Apparent Domestic Consumption	11,837,617	13,899,190	20,629,688	15,517,652	n.a.
Exports as Percent of Apparent Domestic Consumption	8.9%	9.2%	8.3%	9.3%	n.a.
Imports as Percent of Apparent Domestic Consumption	32.9%	32.5%	32.5%	31.4%	n.a.
Exports to Japan (f.a.s.)	153,389	216,727	277,972	148,960	168,876
Imports from Japan (Customs)	502,613	738,186	1,623,087	979,374	1,033,112
Trade Balance	-349,224	-521,459	-1,345,115	-830,414	-864,236
Exports to Japan as Percent of Apparent Domestic Consumption	1.3%	1.6%	1.3%	1.0%	n.a.
Imports from Japan as Percent of Apparent Domestic Consumption	4.2%	5.3%	7.9%	6.3%	n.a.

Source: Derived from following tables.

Table 2: Japan's Apparent Domestic Consumption of Semiconductors, 1982-86*

	1982	1983	1984	1985	1986
	(in millions of yen)				
Total Production	Y1,194,570	Y1,560,174	Y2,584,239	Y2,409,703	Y2,332,521
Total Exports (f.o.b.)	355,325	511,436	898,548	699,090	641,993
Total Imports (c.i.f.)	161,390	188,966	272,310	202,128	174,313
Trade Balance	193,935	322,470	626,238	496,962	467,680
Apparent Domestic Consumption	1,000,635	1,237,704	1,958,001	1,912,741	1,864,841
Exports as Percent of Apparent Domestic Consumption	35.5%	41.3%	45.9%	36.5%	34.4%
Imports as Percent of Apparent Domestic Consumption	16.1%	15.3%	13.9%	10.6%	9.4%
Exports to the United States (f.o.b.)	134,506	206,064	406,144	249,334	187,698
Imports from the United States (c.i.f.)	92,164	116,960	175,858	136,399	118,009
Trade Balance	42,342	89,104	230,286	112,935	69,689
Exports to the United States as Percent of Apparent Domestic Consumption	13.4%	16.6%	20.7%	13.0%	10.1%
Imports from the United States as Percent of Apparent Domestic Consumption	9.2%	9.4%	9.0%	7.1%	6.3%
	(in thousands of dollars)				
Total Production	$4,795,929	$6,568,877	$10,880,090	$10,101,882	$13,841,212
Total Exports (f.o.b.)	1,430,858	2,153,233	3,792,142	2,909,360	3,776,652
Total Imports (c.i.f.)	649,980	795,345	1,149,424	841,604	1,024,888
Trade Balance	780,878	1,357,888	2,642,718	2,067,756	2,751,764
Apparent Domestic Consumption	4,015,051	5,210,989	8,237,372	8,034,126	11,089,448
Exports to the United States (f.o.b.)	541,642	867,565	1,714,049	1,037,638	1,104,171
Imports from the United States (c.i.f.)	371,180	492,277	742,299	567,927	693,844
Trade Balance	170,462	375,288	971,750	469,711	410,327

*Neither Japan's production data nor its trade data include parts.

Source: Derived from following tables.

Table 3: U.S. Shipments of Semiconductors, 1982-85*

(value in thousands of dollars; quantity in thousands of units)

	1982	1983	1984	1985(p)
Value				
Integrated Circuits	$7,321,719	$8,903,267	$13,323,719**	$10,090,309**
Linear	764,254	n.a.	1,934,536	1,444,545
Digital Bipolar	2,143,762	2,789,044	4,332,792	3,335,654
Transistor-Transistor Logic	1,123,849	1,310,805	2,746,097	2,037,010
Other Logic]	1,019,913	1,478,239	901,519	657,689
Memory]			317,211	311,971
Other]			367,965	328,984
Digital MOS	3,559,212	4,895,818	5,069,500	3,885,650
Microprocessors	507,786]	1,601,761	1,053,290	830,468
Logic	1,091,567]		1,154,392	1,146,407
Memory	1,959,859	3,294,057	2,861,818	1,908,775
DRAMs	n.a.	n.a.	1,686,747	1,096,762
SRAMs	n.a.	n.a.	380,990	420,945
ROMs	n.a.	n.a.	129,537	87,803
EPROMs***	n.a.	n.a.	160,770	60,512
EEPROMs***	n.a.	n.a.	14,263	13,581
Other Monolithic	n.a.	406,646	572,381	126,516
Hybrid	854,491	811,759	1,050,513	1,193,386
Discrete Devices	1,672,897	1,749,097	2,329,357	2,007,460
Transistors	596,799	625,720	823,689	668,527
Diodes and Rectifiers	493,517	541,097	661,681	640,869
Other	582,581	582,280	843,987	698,064
Parts	1,734,086	1,828,924	1,742,341	1,534,160
Total Shipments	10,728,702	12,481,288	17,395,417	13,631,929

(continued)

Table 3: U.S. Shipments of Semiconductors, 1982-85* (continued)

(value in thousands of dollars; quantity in thousands of units)

	1982	1983	1984	1985(p)
Quantity				
Integrated Circuits	n.a.	n.a.	n.a.	n.a.
Linear	n.a.	n.a.	1,234,897	908,381
Digital Bipolar	n.a.	n.a.	7,095,066	5,179,875
Transistor-Transistor Logic	n.a.	n.a.	6,536,484	4,801,173
Other Logic	n.a.	n.a.	377,476	187,788
Memory	n.a.	n.a.	54,115	60,852
Other	n.a.	n.a.	126,991	130,062
Digital MOS	n.a.	n.a.	1,093,754	787,888
Microprocessors	n.a.	n.a.	130,558	90,874
Logic	n.a.	n.a.	427,159	384,577
Memory	n.a.	n.a.	536,037	312,437
DRAMs	n.a.	n.a.	271,705	168,597
SRAMs	n.a.	n.a.	47,457	75,096
ROMs	n.a.	n.a.	50,271	28,828
EPROMs***	n.a.	n.a.	13,502	4,921
EEPROMs***	n.a.	n.a.	2,021	1,351
Other Monolithic	n.a.	n.a.	n.a.	n.a.
Hybrid	n.a.	n.a.	n.a.	n.a.
Discrete Devices	n.a.	n.a.	n.a.	n.a.
Transistors	n.a.	n.a.	n.a.	n.a.
Diodes and Rectifiers	2,627,940	3,177,843	3,387,035	2,744,937
Other	n.a.	n.a.	n.a.	n.a.

*Data on 1986 shipments will not be available until late 1987.

**Totals include some products not broken out below.

***Figures do not represent complete product line since data on certain densities of devices are suppressed to avoid disclosing information on individual companies.

Source: U.S. Department of Commerce, Current Industrial Reports: Selected Electronic and Associated Products, Including Telephone and Telegraph Apparatus, 1983 and 1984 (MA-36N); Current Industrial Reports: Semiconductors, Printed Circuit Boards, and Other Electronic Components, 1985 (MA-36Q).

Table 4A: Total U.S. Exports of Semiconductors, 1982-86

(in thousands of dollars)

	1982	1983	1984	1985	1986
Integrated Circuits	$836,261	$1,025,723	$1,391,329	$1,140,636	$1,148,136
Linear	113,228	170,254	275,243	214,054	211,579
Digital Bipolar	133,320	144,668	223,733	177,036	211,579
Logic	97,501	105,786	158,711	136,616	162,869
Memory	35,819	38,882	65,022	40,420	39,855
Digital MOS	413,265	468,376	650,946	606,774	565,666
Microprocessors	91,749	102,382	159,983	101,697	178,570
Logic	131,571	177,963	213,201	219,629	264,019
Memory	189,945	188,031	277,762	205,448	123,077
RAMs	95,346	101,244	165,811	149,415	81,734
Other Monolithic	104,408	138,814	126,577	69,118	92,206
Hybrid	72,040	103,611	114,830	73,654	75,961
Discrete Devices	215,885	259,240	330,391	305,017	347,146
Transistors	81,764	97,897	118,844	123,147	138,760
Diodes and Rectifiers	74,244	89,846	111,710	94,044	108,652
Other	59,877	71,497	99,837	87,826	99,733
Parts	2,745,222	3,076,503	3,612,915	2,793,524	3,374,413
Total Exports	3,797,368	4,361,466	5,334,635	4,239,177	4,869,694

Table 4B: U.S. Exports of Semiconductors to Japan, 1982-86

(value in thousands of dollars: quantity in thousands of units)

	1982	1983	1984	1985	1986
Value					
Integrated Circuits	$142,669	$200,269	$253,707	$130,605	$144,567
Linear	18,081	44,873	81,771	33,574	28,571
Digital Bipolar	26,265	33,815	48,017	24,109	41,959
Logic	18,102	23,508	30,266	13,542	30,852
Memory	8,163	10,307	17,751	10,567	11,107
Digital MOS	75,208	86,839	101,207	60,438	56,149
Microprocessors	16,011	17,951	19,841	18,116	21,263
Logic	23,526	35,183	38,449	16,964	20,729
Memory	35,671	33,705	42,917	25,358	14,158
RAMs	7,139	10,211	19,604	16,785	9,360
Other Monolithic	4,035	5,777	6,868	3,092	7,972
Hybrid	19,080	28,965	15,844	9,392	9,916
Discrete Devices	13,720	16,458	24,265	18,355	24,309
Transistors	6,408	6,823	8,300	5,943	10,165
Diodes and Rectifiers	3,666	4,403	5,729	4,865	5,735
Other	3,646	5,232	10,236	7,547	8,410
Parts	33,971	44,219	85,945	87,746	125,453
Exports to Japan	190,360	260,946	363,917	236,706	294,329
Quantity					
Integrated Circuits	53,100	95,574	159,032	65,690	51,938
Linear	13,244	35,366	75,508	25,885	16,523
Digital Bipolar	13,663	22,708	24,691	12,034	13,520
Logic	9,846	17,945	19,610	7,722	10,507
Memory	3,817	4,763	5,081	4,311	3,013
Digital MOS	20,007	29,570	55,076	26,115	18,669
Microprocessors	3,181	4,861	4,398	3,653	3,780
Logic	9,886	15,595	30,437	11,021	9,233
Memory	6,940	9,115	20,241	11,441	5,656
RAMs	2,468	5,964	10,282	8,992	4,012
Other Monolithic	1,716	2,661	2,409	917	2,670
Hybrid	4,470	5,270	1,348	739	556
Discrete Devices	17,827	25,414	29,737	16,889	26,102
Transistors	7,454	10,990	9,944	6,545	15,403
Diodes and Rectifiers	8,826	12,540	17,245	7,692	8,386
Other	1,547	1,884	2,548	2,651	2,313

Source: U.S. Department of Commerce, U.S. Exports: Schedule E Commodity by Country (FT 410)

Table 5A: Total U.S. Imports of Semiconductors, 1982-86

(in thousands of dollars)

	1982	1983	1984	1985	1986
Integrated Circuits	$3,461,331	$4,075,104	$6,055,156	$4,364,897	$4,508,905
Linear	388,107	482,322	714,834	576,069	597,957
Digital Bipolar	846,904	1,082,397	1,546,691	973,340	1,127,775
Logic	614,683	813,661	1,216,802	754,366	828,203
Transistor-Transistor Logic	513,015	714,456	1,055,437	652,581	712,405
Memory	232,221	268,736	329,889	218,974	249,348
Digital MOS	2,084,522	2,367,695	3,619,199	2,598,305	2,415,840
Microprocessors	267,615	330,169	513,945	349,610	473,561
Logic	442,529	520,085	958,310	824,583	709,738
Memory	1,374,378	1,517,441	2,146,944	1,424,112	1,232,542
RAMs	834,359	1,036,820	1,605,180	947,084	773,376
8K, 16K and 32K	n.a.	486,402	451,102	310,665	226,306
64K	n.a.	510,933	944,841	405,845	173,698
256K	n.a.	39,124	198,748	200,942	353,880
1MB	n.a.	361	10,489	29,632	19,493
Other Monolithic	45,696	44,762	79,405	89,509	113,710
Hybrid	96,102	97,928	95,027	127,674	253,622
Discrete Devices	433,816	446,685	643,176	500,639	580,088
Transistors	259,661	248,137	331,393	242,669	278,657
Diodes and Rectifiers	112,479	129,469	212,150	181,700	215,270
Other	61,676	69,079	99,633	76,270	86,162
Parts	232,514	- 412,690	896,540	806,673	878,427
Total Imports	4,127,661	4,934,479	7,594,872	5,672,209	5,967,420

Table 5B: U.S. Imports of Semiconductors from Japan, 1982-86

(value in thousands of dollars: quantity in thousands of units)

	1982	1983	1984	1985	1986
Value					
Integrated Circuits	$444,967	$677,111	$1,520,346	$879,727	$926,840
Linear	22,397	31,168	51,333	45,348	47,824
Digital Bipolar	70,874	72,607	129,995	93,238	126,072
Logic	40,753	45,899	69,147	41,931	56,748
Transistor-Transistor Logic	7,915	23,918	33,393	15,686	26,626
Memory	30,121	26,708	60,848	51,307	69,324
Digital MOS	328,968	544,410	1,278,259	699,872	692,771
Microprocessors	9,279	29,356	93,137	70,126	85,350
Logic	34,036	67,795	207,017	152,257	169,217
Memory	285,653	447,259	978,105	477,489	438,204
RAMs	215,950	353,098	809,184	372,290	365,869
8K, 16K and 32K	n.a.	117,777	161,330	95,047	58,503
64K	n.a.	209,298	459,082	126,090	56,623
256K	n.a.	26,023	188,772	150,914	232,206
1MB	n.a.	0	0	239	18,537
Other Monolithic	1,516	2,722	23,717	13,511	5,225
Hybrid	21,212	26,204	37,042	27,758	54,948
Discrete Devices	57,646	61,075	102,741	99,647	106,272
Transistors	37,736	32,662	51,516	41,434	48,514
Diodes and Rectifiers	12,530	20,580	40,252	46,970	44,137
Other	7,380	7,833	10,973	11,243	13,620
Parts	80,994	179,553	355,310	337,519	348,557
Imports from Japan	583,607	917,739	1,978,397	1,316,893	1,381,669
Quantity					
Integrated Circuits	193,413	332,663	505,472	332,767	455,745
Linear	31,360	52,162	77,592	48,446	54,800
Digital Bipolar	33,276	68,302	77,805	45,557	79,271
Logic	27,890	63,701	69,533	37,053	70,154
Transistor-Transistor Logic	22,126	56,925	60,124	28,248	61,465
Memory	5,385	4,601	8,273	8,504	9,118
Digital MOS	116,157	191,581	310,515	201,643	294,581
Microprocessors	2,679	6,659	26,486	20,441	27,155
Logic	18,302	38,592	48,779	45,809	85,517
Memory	95,177	146,330	235,251	135,394	181,909
RAMs	68,410	114,525	195,379	106,926	157,183
8K, 16K and 32K	n.a.	51,587	56,132	32,451	33,071
64K	n.a.	61,723	128,133	41,328	27,100
256K	n.a.	1,215	11,114	33,132	95,710
1MB	n.a.	0	0	16	1,303
Other Monolithic	1,674	3,610	21,706	19,700	3,844
Hybrid	10,947	17,008	17,854	17,420	23,249
Discrete Devices	369,836	334,052	452,736	357,282	606,167
Transistors	144,136	91,962	80,609	81,211	194,418
Diodes and Rectifiers	209,083	233,245	359,292	265,649	400,408
Other	16,617	8,845	12,836	10,423	11,342

Source: U.S. Department of Commerce, U.S. Imports for Consumption and General Imports (FT 246)

Table 6: Japan's Production of Semiconductors, 1982-86

(value in millions of yen*; quantity in thousands of units)

	1982	1983	1984	1985	1986(p)
Value					
Integrated Circuits	Y834,883	Y1,139,523	Y1,973,850	Y1,841,790	Y1,780,101
Linear	176,332	222,279	331,419	350,333	338,166
For Industrial Equipment	41,777	45,082	68,541	70,588	83,229
For Consumer Goods	134,555	177,197	262,878	279,745	254,937
Digital Bipolar	130,493	153,371	261,004	256,076	273,390
Logic	104,232	130,805	223,726	214,827	230,052
Memory	26,261	22,566	37,278	41,249	43,337
Digital MOS	436,646	663,643	1,235,596	1,070,965	999,305
Logic	208,177	296,387	481,885	482,095	483,544
Memory	228,469	367,256	753,711	588,870	515,760
Hybrid	91,412	100,230	145,831	164,417	169,241
Discrete Devices	359,687	420,651	610,389	567,913	552,420
Transistors	143,457	152,726	224,845	206,205	196,041
Diodes and Rectifiers	102,129	122,004	170,763	142,752	139,900
Other	114,101	145,921	214,781	218,956	216,479
Total Production	1,194,570	1,560,174	2,584,239	2,409,703	2,332,521
Quantity					
Integrated Circuits	4,381	6,230	9,516	9,350	11,144
Linear	1,641	2,252	3,463	3,624	3,972
For Industrial Equipment	377	443	653	646	1,026
For Consumer Goods	1,264	1,810	2,809	2,978	2,946
Digital Bipolar	963	1,387	2,230	1,882	2,379
Logic	935	1,355	2,188	1,838	2,334
Memory	29	32	41	44	45
Digital MOS	1,559	2,311	3,486	3,485	4,364
Logic	1,021	1,571	2,334	2,358	2,889
Memory	537	741	1,152	1,127	1,475
Hybrid	219	279	338	360	428
Discrete Devices	21,555	28,077	42,406	38,283	43,087
Transistors	8,372	9,387	14,391	14,343	15,769
Diodes and Rectifiers	10,000	14,500	22,273	18,702	20,576
Other	3,183	4,191	5,743	5,237	6,743

*The following average annual exchange rates, calculated by the Ministry of Finance, can be used to convert the yen production figures into dollars: 1982, Y249.08; 1983, Y237.51; 1984, Y237.52; 1985, Y238.54; and 1986, Y168.52.

Source: Japan, Ministry of International Trade and Industry, Yearbook of Machinery Statistics

Table 7A: Japan's Total Exports of Semiconductors, 1982-86

(in millions of yen*)

	1982	1983	1984	1985	1986
Integrated Circuits	Y285,112	Y423,836	Y776,775	Y581,801	Y523,131
Packaged	223,670	345,467	669,891	486,169	436,030
Unpackaged	61,443	78,370	106,884	95,632	87,101
Discrete Devices	70,213	87,600	121,773	117,290	118,862
Packaged	59,305	74,041	103,288	100,747	101,516
Transistors	21,801	24,820	30,223	30,429	28,505
Diodes and Rectifiers	16,307	20,630	28,426	24,247	25,658
Other	21,197	28,591	44,638	46,071	47,354
Unpackaged	10,908	13,558	18,485	16,543	17,346
Total Exports	355,325	511,436	898,548	699,090	641,993

Table 7B: Japan's Exports of Semiconductors to the United States, 1982-86

(in millions of yen*)

	1982	1983	1984	1985	1986
Integrated Circuits	Y116,760	Y184,321	Y372,206	Y219,537	Y163,940
Packaged	109,893	170,630	349,946	207,244	154,737
Unpackaged	6,867	13,691	22,260	12,292	9,203
Discrete Devices	17,746	21,743	33,938	29,798	23,758
Packaged	16,919	20,661	32,167	27,692	21,869
Transistors	5,661	6,086	8,176	6,032	5,036
Diodes and Rectifiers	3,421	3,864	5,165	3,778	3,907
Other	7,838	10,711	18,826	17,882	12,926
Unpackaged	827	1,081	1,771	2,106	1,889
Exports to the United States	134,506	206,064	406,144	249,334	187,698

*The following average annual exchange rates, calculated by the Ministry of Finance, can be used to convert the yen export figures into dollars: 1982, Y248.33; 1983, Y237.52; 1984, Y236.95; 1985, Y240.29; and 1986, Y169.99.

Source: Japan Tariff Association, Japan Exports and Imports: Commodity by Country

Table 8A: Japan's Total Imports of Semiconductors, 1982-86

(in millions of yen*)

	1982	1983	1984	1985	1986
Integrated Circuits	Y127,382	Y152,602	Y222,176	Y165,439	Y146,075
Packaged	109,874	137,065	201,495	137,851	118,895
Digital	73,627	95,240	144,094	95,407	83,355
Other	36,248	41,825	57,402	42,444	35,540
Unpackaged	17,508	15,537	20,681	27,588	27,180
Discrete Devices	34,008	36,364	50,134	36,690	28,238
Packaged	33,864	36,006	48,739	34,983	27,598
Transistors	16,434	16,791	22,954	15,391	11,284
Diodes and Rectifiers	6,007	5,916	7,300	4,536	4,643
Other	11,424	13,298	18,485	15,056	11,671
Unpackaged	144	358	1,396	1,707	639
Total Imports	161,390	188,966	272,310	202,128	174,313

Table 8B: Japan's Imports of Semiconductors from the United States, 1982-86

(in millions of yen*)

	1982	1983	1984	1985	1986
Integrated Circuits	Y83,494	Y107,605	Y163,619	Y125,381	Y110,085
Packaged	71,349	95,608	145,631	102,160	88,179
Digital	55,696	73,155	113,195	78,536	68,503
Other	15,653	22,454	32,436	23,624	19,677
Unpackaged	12,145	11,996	17,989	23,222	21,906
Discrete Devices	8,670	9,355	12,238	11,018	7,924
Packaged	8,569	9,042	10,941	9,566	7,533
Transistors	2,102	1,951	2,320	2,173	1,985
Diodes and Rectifiers	1,397	1,614	1,821	1,742	1,445
Other	5,071	5,477	6,800	5,651	4,102
Unpackaged	101	313	1,298	1,452	391
Imports from the United States	92,164	116,960	175,858	136,399	118,009

*The following average annual exchange rates, calculated by the Ministry of Finance, can be used to convert the yen import figures into dollars: 1982, Y248,30; 1983, Y237.59; 1984, Y236.91; 1985, Y240.17; and 1986, Y170.08.

Source: Japan Tariff Association, Japan Exports and Imports: Commodity by Country

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And The Winner Is . . .

After months of jockeying for position, Liberal Democratic Party secretary general Noboru Takeshita has finally emerged as the party's choice to succeed Yasuhiro Nakasone as president. Although the outcome was no surprise, the ending to this long drama had a special twist. Unable to agree on a successor, the three top candidates for the post turned to the outgoing president as a final arbitrator. With his usual flair for the dramatic, Mr. Nakasone sent his decision via his personal emissary, who revealed the choice to the three contenders -- Mr. Takeshita, Finance Minister Kiichi Miyazawa and LDP executive council chairman Shintaro Abe -- early in the morning of October 20.

Higher Yen Reins In Japan's Trade Surplus

The big drop in the dollar's trade-weighted value since February 1985 will not trim the huge U.S. trade deficit this year, Reagan administration officials and business economists have conceded in the wake of another bigger-than-expected monthly shortfall in August. In fact, few people are now willing to venture a guess about the timing of a turnaround in the red-ink trade entry, although policymakers repeatedly point out that the imbalance corrected for price changes has improved significantly since 1986's third quarter.

Japan's trade results have also defied the conventional wisdom about how fast export and import numbers should respond to exchange rate changes, but the parallels between what has happened in Japan and in this country end there. Not only is the steep run-up in the yen's value over the last two-and-one-half years moving trade flows in the right direction; there is strong evidence that the corner has been turned. For starters, Japan's trade surplus in dollar terms dropped in the July-September period for the second straight quarter after 17 quarters of back-to-back gains. Then there is the fact that the monthly imbalance has been running behind year-earlier totals since May as a result of double-digit import hikes dating back to the same time and seven consecutive months of single-digit increases in exports.

But volume figures provide the clearest proof that Japan's enormous trade surplus is indeed headed down. Price-adjusted exports, which had dipped 1.4 percent in 1986, declined every month between February and September for an additional cutback of 2.4 percent at this year's nine-month mark. At the same time, imports in volume terms continued to build on their 1986 gain of 13.3 percent, rising by an extra 6 percent through September, as stronger Japanese domestic demand reinforced the effects of the higher yen. Behind this expansion, government spokesmen note at every opportunity, were bigger purchases of foreign manufactured products -- up 6.7 percent in real terms as of August on top of a 1986 jump of 24.4 percent.

Change in Volume of Japan's Exports and Imports

		Exports	Imports
1982		-2.4%	-0.6%
1983		8.7	1.3
1984		15.4	10.7
1985		4.7	0.2
1986		-1.4	13.3
1985:	I	6.9	0.6
	II	6.8	-0.4
	III	4.0	-2.8
	IV	1.8	3.3
1986:	I	-0.2	3.6
	II	-0.9	16.8
	III	-0.3	18.7
	IV	-4.2	14.4
1987:	I	-0.1	8.1
	II	-3.9	3.6
	III	-3.0	6.6

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1982	$138,831	-8.7%	$131,931	-7.9%	$6,900
1983	146,928	5.8	126,393	-4.2	20,534
1984	170,114	15.8	136,503	8.0	33,611
1985	175,638	3.2	129,539	-5.1	46,099
1986	209,151	19.1	126,408	-2.4	82,743
1985: I	38,503	-1.3	32,513	-5.7	5,991
II	43,748	0.6	32,094	-7.0	11,654
III	43,909	2.7	31,239	-8.1	12,671
IV	49,478	10.3	33,693	0.5	15,785
1986: I	45,499	18.2	33,005	1.5	12,494
II	53,166	21.5	31,424	-2.1	21,742
III	54,768	24.7	30,153	-3.5	24,615
IV	55,718	12.6	31,826	-5.5	23,892
1987: I	51,478	13.1	31,940	-3.2	19,539
II	56,946	7.1	36,357	15.7	20,589
III	57,833	5.6	38,299	27.0	19,535

Japan's Total Trade in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1982	Y34,433	2.9%	Y32,656	3.8%	Y1,776
1983	34,909	1.4	30,014	-8.1	4,895
1984	40,325	15.5	32,321	7.7	8,004
1985	41,956	4.0	31,085	-3.8	10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1985: I	9,898	9.5	8,340	4.3	1,559
II	11,025	11.1	8,093	2.8	2,932
III	10,591	2.4	7,534	-8.3	3,057
IV	10,442	-5.3	7,118	-13.6	3,323
1986: I	8,674	-12.4	6,334	-24.1	2,339
II	9,119	-17.3	5,399	-33.3	3,720
III	8,632	-18.5	4,758	-36.8	3,874
IV	8,865	-15.1	5,060	-28.9	3,806
1987: I	7,962	-8.2	4,953	-21.8	3,010
II	8,156	-10.6	5,204	-3.6	2,952
III	8,504	-1.5	5,637	18.5	2,867

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1982	$36,330	-5.9%	$24,179	-4.4%	$12,151
1983	42,829	17.9	24,648	1.9	18,181
1984	59,937	39.9	26,862	9.0	33,075
1985	65,278	8.9	25,793	-4.0	39,485
1986	80,456	23.3	29,054	12.6	51,401
1985: I	13,346	6.8	6,771	1.3	6,575
II	16,837	9.0	6,641	-1.6	10,196
III	16,615	5.4	6,111	-9.8	10,504
IV	18,480	13.9	6,270	-5.7	12,211
1986: I	16,696	25.1	6,278	-7.3	10,418
II	20,921	24.3	8,305	25.1	12,616
III	21,280	28.1	7,525	23.1	13,755
IV	21,559	16.7	6,946	10.8	14,613
1987: I	18,003	7.8	6,961	10.9	11,041
II	21,187	1.3	7,589	-8.6	13,599
III	21,616	1.6	8,235	9.4	13,381

Japan's Trade with the United States in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1982	Y9,015	5.8%	Y5,991	7.9%	Y3,025
1983	10,179	12.9	5,855	-2.3	4,323
1984	14,221	39.7	6,364	8.7	7,858
1985	15,583	9.6	6,213	-2.4	9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1985: I	3,429	18.3	1,737	11.9	1,692
II	4,244	20.4	1,674	8.8	2,569
III	4,008	5.2	1,474	-10.0	2,534
IV	3,903	-2.1	1,328	-18.7	2,575
1986: I	3,191	-6.9	1,203	-30.7	1,988
II	3,589	-15.4	1,421	-15.1	2,168
III	3,355	-16.3	1,190	-19.3	2,165
IV	3,429	-12.1	1,104	-16.9	2,325
1987: I	2,786	-12.7	1,080	-10.3	1,707
II	3,035	-15.4	1,085	-23.6	1,950
III	3,178	-5.3	1,212	1.9	1,966

Although the appreciation of the yen has finally reversed the growth of Japan's trade surplus, Tokyo still has a tough public relations job on its hands because the full-year 1987 number will be just shy of last year's record surplus of $82.7 billion. Through September, for example, exports topped imports by $59.7 billion -- $0.9 billion more than in the first three quarters of 1986, with overseas sales up 8.3 percent to $166.3 billion and purchases from abroad 11.3 percent higher at $106.6 billion. Tokyo's hardest campaign, however, will be convincing Washington that the bilateral surplus is contracting since the turnabout in Japan-U.S. trade only dates from mid-year. That one quarter lag virtually guarantees that the black-ink entry this year will top 1986's record $51.4 billion figure by at least a small amount.

Susan MacKnight

Tax Reform Again Heads FY 1988 Agenda

While the dust has not settled in Japan from this spring's battle to pass the most significant tax reform ever, calls for further changes have already been raised. After a bruising political battle between the ruling Liberal Democratic Party and the opposition that paralyzed the parliament for nine months, political, government and business leaders are now urging changes in other areas. These include:

- Capital gains tax - On October 8 the Ministry of Finance suggested that a modest tax on capital gains should be instituted in the interest of tax fairness and to balance the impact of the personal income-tax cuts approved in early September (see JEI Report No. 35B, September 18, 1987). The proposal is also a response to opposition party criticism that the tax system favors the rich. Currently, capital gains from stock trading are virtually tax-free because the tax threshold is very high (50 deals a year involving more than 200,000 shares). Although the threshold will drop January 1, 1988 to 30 transactions of more than 120,000 shares, most deals will still be excluded.

- Indirect tax - Despite being forced to withdraw this proposal for FY 1987, MOF, the LDP and Keidanren (the Federation of Economic Organizations) favor instituting a significant indirect tax in fiscal 1988. Beyond agreement that the tax should be broad-based, no details have been worked out. Before proceeding with legislation the government and the LDP will certainly try to prepare a broad consensus on this issue to avoid a repeat of this session's problems.

- Business taxes - In an October 14 report, Keidanren called for an overhaul of corporate income taxes, depreciation rules and other business taxes. "Equal burden sharing" should be the goal of tax reform, the business lobby argued, because Japan's society is aging and the economy is undergoing structural adjustment. The report lacked specific details, however.

- Liquor tax - Responding to complaints from foreign distillers (particularly European), MOF has proposed abolishing the ad valorem tax on liquor effective April 1, 1988; quantity-based taxes will remain, however (see JEI Report No. 20A, May 22, 1987). The system of whiskey grading will also be dropped and a new tax rate set somewhere between the current levies on special- and first-class grades. In addition, the quality classifications for wine and other liqueurs will be abolished. The number of sake (rice wine) grades will

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JAPAN'S FOREIGN AID POLICY: 1987 UPDATE

Summary

In the last year the importance of Japan's economic assistance programs has continued to grow, providing evidence that Tokyo intends to take its "responsibilities as a surplus nation" seriously. Its announcement of several foreign aid initiatives drew worldwide attention, especially its pledge to commit $30 billion in additional funds to the developing countries over a three-year period. Moreover, the appreciation of the yen and a modest real increase in official development assistance disbursements combined to make Tokyo's aid figure skyrocket -- thus bringing Japan back to the number-two donor position. Ironically, though, the new initiatives served to increase cries for Tokyo to do even more to alleviate global debt and development problems. This report will discuss the scope of the new initiatives, the regional aid strategies being proposed, and the significance of the past year for future Japanese aid programs.

Introduction

Japan's official development assistance program is unique in many respects. The economy's rapid growth in the postwar era put Japan in the unusual situation of being a developing and then an ODA donor nation within a very short time. This streamlined economic development was reflected in a succession of rapid changes in Tokyo's ODA program. A 1985 study by aid experts

William L. Brooks and Robert M. Orr* outlined four stages of aid policy. Japan's first foray into aid programs in the mid-1950s took the form of reparations, and although the emphasis shifted after 1965 to foreign aid, the goal remained the same: export promotion -- mainly in Asia -- through tied aid.

It was not until the oil crises of the 1970s that Tokyo began to look beyond Asia to resource-rich developing countries in an attempt to secure the natural resources that are vital to the smooth functioning of the Japanese economy. "Resource diplomacy" was extended to include other political and strategic considerations in the late 1970s when crises in Iran and Afghanistan led Tokyo to further broaden the scope and quality of its aid flows.

Since 1980 Japan has espoused a "basic human needs" approach to aid -- policies to improve the condition of the poor directly rather than to focus on large-scale projects. To do so Tokyo selected four areas of emphasis: rural and agricultural programs; development of new and renewable energy sources; human resource development; and improvement of small- and medium-sized businesses. Inherent in this approach is a commitment to improve the quality of ODA disbursements. Tokyo has also retained its commitment to consider overall security factors when pledging assistance; its policy is to increase aid to those areas that are "important for the maintenance of world peace and stability." It will not, however, extend military assistance to developing countries.

Tokyo's emphasis on basic human needs represents its attempt to deal with another situation that sets Japan's program apart from those of other donors. More than any other government, Tokyo suffers from a perception that its aid program remains largely export-oriented. In response to this problem, Japan has stressed the alleviation of poverty and humanitarian aid -- including emergency and disaster relief -- as well as increased funds for countries with which it has few economic ties, for example, sub-Saharan Africa.

A third factor that contributes to Japan's singularity is its constitutional pledge not to significantly expand its military capabilities. Because this policy restricts the ways it can contribute to international security, Japan has opted to use foreign aid as its primary contribution. Maintaining that economic stability is a necessary prerequisite for political security, Tokyo's assistance has become a major element in discussions of support for the Western alliance. In light of recurring calls from Washington for defense "burdensharing," Tokyo has in a very real sense staked its international credibility as a major power on the effectiveness of its aid program.

Not surprisingly, ODA has become a Japanese bargaining tool not only with developing nations but also with other industrialized countries. Japanese officials are all too sensitive to complaints in this country about its enormous current account surplus as well as the growing perception that the United States rather than Japan has purchased the lion's share of developing-country

*Willim L. Brooks and Robert M. Orr, Jr., "Japan's Foreign Economic Assistance," Asian Survey, XXV, No. 3, (March 1985), p. 323.

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manufactured goods, which has exacerbated the U.S. trade deficit. Indeed, Tokyo's oft-used phrase, "Japan's responsibilities as a surplus nation," contains an implicit recognition of the link between U.S.-Japan economic frictions and Tokyo's policies toward the third world. Thus, trade tensions have prompted Tokyo to expand its assistance programs in response to U.S. complaints.

A final unique element of Japan's ODA policy is its emphasis on partnership. Unlike the assistance programs of former colonial powers and the United States, which appear to be more benefactor/recipient oriented, Tokyo stresses "economic cooperation" and "self-help." In the past this translated into higher interest rates and tougher repayment schedules than other donors' loans on the grounds that economic assistance is more effective when obligations and incentives are an integral part of the prgrams. More recently, loans on concessional terms have become more common. Still, the conviction that aid is a partnership is reflected in other ways. For example, officials are reluctant to dictate the types of aid projects that recipients need or to insist on strict oversight activities; rather, they argue that the recipient countries should choose and implement their own development strategies.

Japan's Official Development Assistance in 1986

According to Alan Rix**, Tokyo gives economic assistance to no less than 134 developing countries or territories. Moreover, it has in recent years been the third-largest donor among Organization for Economic Cooperation and Development members after the United States and France (except for a short stint as number-two in 1984). Disbursements soared in 1986 to $5.6 billion -- an increase of 48.4 percent (see Table 1) -- restoring Tokyo to second place (see Table 2). This surge is in sharp contrast to 1985's results, when disbursements fell by 12.1 percent (see JEI Report No. 39A, October 24, 1986).

Much of the change can be attributed to the sharp appreciation of the yen, however. The bulk of Japan's aid is yen-denominated, but the Development Assistance Committee of the OECD calculates ODA in dollar terms. In 1985 the exchange rate averaged Y238.54=$1.00; last year it was Y168.52 -- 41.6 percent higher. Indeed, in yen terms 1986's increase was merely 4.8 percent, with bilateral flows (which are disbursed primarily in yen) rising by 6.3 percent and multilateral flows (largely in dollars) by 1.9 percent. The DAC estimates that in real terms, the increase in Japan's aid amounted to approximately 3 percent, slightly higher than the DAC average.

Other indicators remain below the DAC average, however. Japan's ODA/GNP ratio remained steady at 0.29 percent last year -- significantly below the DAC average of 0.36 (see Table 3) -- holding Tokyo's rank fourteenth of the 18 DAC members. In 1984 its ratio had reached 0.35 percent, close to the average 0.36 percent, but still below the United Nations-recommended level of 0.7 percent.

The quality of aid -- measured by the grant element of ODA -- is another way of evaluating aid programs. Tokyo's ratio of grants to total ODA has consistently been on the low side but it jumped from 73.5 percent in 1985 to 80 percent in 1986. While this is a significant improvement, the grant element is still below the OECD's 86 percent target.

**Alan Rix, Japan's Aid Program (International Development Issues No. 1), Australian Government Publishing Service, 1987.

Table 1: Net Flow of Financial Resources from Japan to Developing Countries and Multilateral Agencies, 1982-86

(in millions of dollars)

Type of Transaction	1982	1983	1984	1985	1986	Percent Change 1985/86
Official Development Assistance	$3,023	$3,761	$4,319	$3,797	$5,634	48.4%
Change Over Previous Year	-4.7%	24.4%	14.8%	-12.1%	48.4%	
ODA/GNP Ratio	0.28%	0.33%	0.34%	0.29%	0.29%	
Bilateral Assistance	2,367	2,425	2,427	2,557	3,846	50.4
Grants	805	993	1,064	1,185	1,703	43.8
Capital Grant Assistance	412	535	543	636	855	34.3
Technical Assistance	393	458	521	549	849	54.7
Development Lending and Capital	1,562	1,432	1,363	1,372	2,143	56.2
Grants, Capital Subscription and Loans to Multilateral Agencies	656	1,336	1,891	1,240	1,788	44.2

Notes: 1. Net disbursement basis.
2. Due to rounding, the figures do not necessarily add up to the totals.

Source: Ministry of Foreign Affairs

Table 2: ODA of Major Donor Countries, 1983-86

(in millions of dollars)

1986 Rank	Country	1983	1984	1985	1986*	Share of Total DAC ODA 1986*
1	United States	$8,081	$8,711	$9,403	$9,784	26.4%
2	Japan	3,761	4,319	3,797	5,634	15.2
3	France**	3,815	3,788	3,995	5,136	13.9
4	West Germany	3,176	2,782	2,942	3,879	10.5
5	United Kingdom	1,610	1,418	1,530	1,750	4.7
6	Netherlands	1,195	1,268	1,136	1,738	4.7
7	Canada	1,429	1,625	1,631	1,700	4.6
DAC Total		27,560	28,686	29,429	37,021	100.0

*Preliminary.
**Including overseas territories and prefectures.

Source: Organization for Economic Cooperation and Development

Table 3: ODA as Percentage of GNP for DAC Countries, 1983-86

(in millions of dollars)

1986 Rank		1983		1984		1985		1986*		Percent Change 1985/86*
		Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP	
1	Norway	$584	1.10%	$543	1.02%	$574	1.01%	$796	1.20%	38.7%
2	Netherlands	1,195	0.91	1,268	1.02	1,136	0.91	1,738	1.00	53.0
3	Denmark	395	0.73	449	0.85	440	0.80	695	0.89	58.1
4	Sweden	754	0.84	741	0.80	840	0.86	1,090	0.85	29.8
5	France**	3,815	0.74	3,788	0.77	3,995	0.78	5,136	0.72	28.6
6	Australia	753	0.49	777	0.46	749	0.48	787	0.49	5.1
7	Belgium	480	0.69	433	0.56	440	0.55	542	0.48	23.1
7	Canada	1,429	0.45	1,625	0.50	1,631	0.49	1,700	0.48	4.2
9	Finland	153	0.32	178	0.36	211	0.40	313	0.45	48.3
10	West Germany	3,176	0.48	2,782	0.45	2,942	0.47	3,879	0.43	31.9
11	Italy	834	0.24	1,133	0.33	1,098	0.31	2,423	0.40	120.7
12	United Kingdom	1,610	0.35	1,418	0.33	1,530	0.33	1,750	0.32	14.4
13	Switzerland	320	0.31	286	0.30	302	0.31	429	0.30	41.8
14	Japan	3,761	0.32	4,319	0.35	3,797	0.29	5,634	0.29	-48.4
15	Ireland	n.a.	n.a.	35	0.22	39	0.24	62	0.28	58.8
16	New Zealand	61	0.28	55	0.25	54	0.25	66	0.27	21.0
17	United States	8,081	0.24	8,711	0.24	9,403	0.24	9,784	0.23	4.1
18	Austria	158	0.24	181	0.28	248	0.38	197	0.21	-20.6
DAC Total		27,560	0.35	28,686	0.36	29,429	0.35	37,021	0.36	25.8

*Preliminary.
**Including overseas territories and prefectures.

Source: Organization for Economic Cooperation and Development

Despite these statistics, DAC considers the outlook for Japan's aid program "favorable," primarily because of Tokyo's Third Medium-Term Target, that is, its third aid-doubling plan. The first, announced in 1977, was designed to double the level of that year's disbursements within five years; the goal was met easily as outlays rose from $1.4 billion in 1977 to $3.3 billion in 1980. A second, similar increase was announced for the 1981-85 period. However a slowdown in domestic growth brought fiscal austerity to Japan which -- combined with a sharp depreciation of the yen -- made it impossible to reach the $21.4 billion aggregate goal.

As for the current plan, which was announced in September 1985, Japan has pledged to disburse more than $40 billion in the 1986-92 period as well as to double 1985's $3.8 billion ODA figure in 1992. While the measurable elements of the target reflect the quantity of aid, the plan also stresses improved quality though "effective and efficient implementation." Five goals have been selected with regard to the quality of aid: improved implementation procedures; better coordination between technical assistance and financial allocations; specific evaluation of aid projects; improved coordination with the private sector; and cooperation with other donor countries and international organizations.

In the first half of this year, Tokyo announced that it had narrowed the time frame for the doubling and the $40 billion aggregate goals; it now plans to achieve both by yearend 1990. This decision stemmed from at least two factors. First, some government officials reportedly advocated a shortened time frame in order to take advantage of the strong yen. The sharply inflated dollar value of Japanese disbursements has already brought Tokyo significantly closer to its target. Second, the new target date was announced in conjunction with a domestic stimulus package. Thus, the more ambitious ODA package, along with measures designed to increase Japanese demand, was in part an attempt to quell American criticism of Tokyo's economic policies.

Because of the yen's appreciation, however, doubling the 1985 ODA figure in seven years would have required only an approximate 5.5 percent average annual increase in outlays from now on. The decision earlier this year to shorten the time frame allows the government to take advantage of the strong yen, make the target more ambitious and enhance the visibility of its aid programs all at the same time. In order to disburse some $7.6 billion in 1990, average annual increases of 8 percent will be necessary. This does not appear out of reach, given Tokyo's willingness to expand its aid flows by some 7 percent annually in yen terms and the fact that the exchange rate could easily jump higher than 1986's average -- at least in the foreseeable future.

Still, although the 1985 aid-doubling goal is virtually assured, it is not certain whether Tokyo will disburse the $40 billion total also outlined in the Third Medium-Term Target. Even if Japan disburses $7.6 billion in 1990 (assuming a 8 percent annual growth), the total for the 1986-90 period will only add up to about $33 billion using 1986's exchange rate. Conversely, if Tokyo retains its 7 percent annual increase in ODA outlays, an average exchange rate of Y135.7 would be needed to reach the $40 billion mark.

Recycling the Surplus for LDC Development

Even more important than the revisions to the doubling plan was Japan's decision to pump some $30 billion into the developing countries over a three-year period. Announced by Prime Minister Yasuhiro Nakasone earlier this year, the plan consists of roughly $10 billion that had been previously pledged to multilateral lending institutions, and another $20 billion designed to recycle a portion of Japan's current account surplus directly to the developing countries. A more detailed breakdown follows.

$10 Billion to Multilateral Development Institutions

$2.6 billion - FY 1988-1990 subscriptions to the International Development Agency (the low-interest arm of the World Bank).

$3.6 billion - (3 billion in Special Drawing Rights) for the International Monetary Fund as a special facility to deal with unusually critical situations that require "financial support beyond the usual recourse."

$2.0 billion - Special fund for the World Bank: $200 million in grant money from Japan and $1.8 billion to be raised by the World Bank in the Tokyo capital market.

$1.3 billion - Funds for the Asian Development Foundation (a window of the Asian Development Bank).

$9.5 billion - Total

$20 Billion Recycling Initiative

$8.0 billion - Further government contributions to multilateral lending agencies, including the World Bank, the Inter-American Development Bank, the Asian Development Bank and the African Development Bank.

$9.0 billion - Untied loans by the Overseas Economic Cooperation Fund, the Export-Import Bank of Japan and possibly private banks co-financed by the World Bank. (Projects are to be chosen in consultation with the World Bank and will follow the strict lending standards of the Bank.)

$3.0 billion - Export-Import Bank untied loans.

$20 billion - Total.

The recycling program is primarily a response to debt rather than development problems. While particularly aimed at the Latin American countries, officials have stressed that debtor nations in other parts of the world will receive funds as well. Recipients will probably be middle-income developing countries, say officials, since ODA is more appropriate for poorer LDCs and LLDCs (least developed countries). Nonetheless, some of the recycling monies are certain to qualify as official development assistance according to DAC criteria. One Japanese official indicated that he would like to see between one-fourth and one-third of the $20 billion qualify as ODA.

What may be more significant about the recycling plan is the precedent that it sets for Japanese aid policy. In the past Tokyo has stressed that the private sector should be wholly responsible for finding a solution to the debt crisis, and has emphasized the importance of new private loans and increased direct investment. However, the existence of a plan that outlines several possible governmental responses to the debt problem suggests that Tokyo may be considering the need to expand the scope of its assistance programs to include debt as well as development issues. If this is the case, the endorsement of Treasury Secretary James Baker's emphasis on a private-sector solution to the debt crisis may give way to a recognition of the need for government involvement -- or, at the very least, increased government private-sector cooperation.

Japanese officials have already called for more multilateral initiatives to promote debt-to-equity swaps, provide risk insurance and develop other responses to the problem. No major new steps will be taken at the national level, they say, until Tokyo can assess the effectiveness of the recycling policy. Still, the innovativeness of the recycling plan may portend more to come. (For a discussion of Japan's response to the Latin American debt crisis, see JEI Report No. 29A, July 31, 1987.)

Taking the Lead in Multilateral Initiatives: MIGA

Tokyo again seized the initiative in June, becoming the first industrialized country to ratify the convention establishing the Multilateral Investment Guarantee Agency. Thirteen developing nations have already ratified the convention, while 45 other countries (including the United States) have signed but not officially adopted the document. Although Japan had initially intended to follow Washington's lead, it reversed its decision -- partly in preparation for last June's economic summit in Venice and partly because of mounting uncertainty as to whether the United States would ratify the convention.

As proposed, MIGA would consist of members of the World Bank and Switzerland and would issue guarantees against non-commercial risks to participants willing to invest in a member developing nation. These include (1) losses due to currency transfers; (2) losses incurred by expropriation or similar actions; (3) losses associated with a breach of contract; and (4) losses stemming from war and civil disturbance. MIGA would also guarantee other types of non-commercial risks if specifically requested by the investor and the host country (see JEI Report No. 22B, June 12, 1987).

A Changing Global Outlook?

Japan has always given the bulk of its ODA to Asia, stressing its historic, political and economic ties with the region as well as its responsibility to contribute to the economic stability of the continent. In fact, by the end of the 1970s a 7-1-1-1 formula was institutionalized: approximately 70 percent of total disbursements went to Asia, while Africa, Latin America and the Middle East received roughly 10 percent apiece. While this ratio has begun to change in recent years, Asia will hold the number-one position -- by a long shot -- for the foreseeable future. In 1986 it received some 65 percent of total disbursements (see Table 4); moreover, Asian countries accounted for nine of Japan's top ten aid recipients (see Table 5).

Table 4: Japan's Bilateral ODA by Region, 1981-86

(in millions of dollars)

Year	Total	Asia	Middle East	Africa	Latin America	Europe	Oceania	Unallocable
1981	$2,260 (100.0%)	$1,605 (71.0%)	$190 (8.4%)	$211 (9.3%)	$177 (7.8%)	$-2 (-0.1%)	$19 (0.9%)	$62 (2.7%)
1982	$2,367 (100.0%)	$1,624 (68.6%)	$194 (8.2%)	$268 (11.3%)	$184 (7.8%)	$-3 (-0.1%)	$23 (1.0%)	$77 (3.2%)
1983	$2,425 (100.0%)	$1,614 (66.5%)	$150 (6.2%)	$287 (11.8%)	$241 (9.9%)	$23 (1.0%)	$18 (0.7%)	$93 (3.8%)
1984	$2,427 (100.0%)	$1,594 (65.7%)	$249 (10.3%)	$211 (8.7%)	$229 (9.4%)	$1 (0.0%)	$25 (1.0%)	$117 (4.8%)
1985	$2,557 (100.0%)	$1,732 (67.8%)	$201 (7.9%)	$252 (9.9%)	$225 (8.8%)	$1 (0.0%)	$24 (0.9%)	$122 (4.8%)
1986	$3,846 (100.0%)	$2,494 (64.8%)	$340 (8.8%)	$418 (10.9%)	$317 (8.2%)	$2 (0.1%)	$55 (1.4%)	$221 (5.7%)

Note: Net disbursement basis.

Source: Ministry of Foreign Affairs

Table 5: Major Recipients of Japan's ODA, 1982-86

(in millions of dollars)

1982		1983		1984		1985		1986	
Country	Amount	Country	Amount	Country	Amount	Country	Amount	Country	Amount
China	$369	China	$350	China	$389	China	$388	China	$497
Indonesia	295	Thailand	248	Malaysia	245	Thailand	264	Philippines	438
Bangladesh	216	Indonesia	236	Thailand	232	Philippines	240	Thailand	260
Thailand	170	Philippines	147	Indonesia	168	Indonesia	161	Bangladesh	248
Philippines	137	India	130	Philippines	160	Burma	154	Burma	244
Burma	104	Burma	114	Bangladesh	123	Malaysia	126	India	227
Pakistan	95	Bangladesh	104	Burma	95	Bangladesh	121	Indonesia	161
Malaysia	75	Malaysia	92	Egypt	81	Pakistan	93	Pakistan	152
Sri Lanka	62	Sri Lanka	73	Pakistan	67	Sri Lanka	84	Sri Lanka	127
Egypt	62	Pakistan	73	Sri Lanka	64	Egypt	73	Egypt	126

Note: Net disbursement basis.

Source: Ministry of Foreign Affairs

Until recently, however, there appeared to be only sketchy policies regarding other regions, except that each would receive about 10 percent of Japan's annual foreign aid. With the announcement of the recycling plan, Japan has begun to outline specific differences in its regional aid policies.

Asia - The major recipients of Japanese aid in Asia are the People's Republic of China, members of the Association of Southeast Asian Nations and Burma. This region is important enough to Japan to warrant a discussion of three sub-regions:

Northeast Asia - Almost all of Tokyo's aid to Northeast Asia goes to the PRC. China has displaced ASEAN members as the top recipient -- with almost 13 percent of Japan's bilateral disbursements -- and has held that position since 1982. China has reportedly been promised at least $700 million of the $20 billion in recycling funds. South Korea also used to be a major recipient of Japanese aid. Today, however, although a fair percent of Japanese money is in Korea, little of it qualifies as ODA. In 1986, for example, Korea's total ODA from Japan was negative -- meaning that loan repayments exceeded the amount of new loans and grants.

Southeast Asia - ASEAN members (Thailand, Indonesia, Singapore, the Philippines, Malaysia and Brunei) were heartened by Foreign Minister Tadashi Kuranari's pledge of a $2 billion "ASEAN Fund" last June. According to Prime Minister Nakasone, the fund will be used to stimulate the "growth of the private industrial sector, including joint ventures, and [to] contribute to the future development of financial markets in the ASEAN area (see JEI Report No. 39B, October 10, 1987, and JEI Report No. 14A, April 10, 1987).

ASEAN countries received some 24 percent of total bilateral flows in 1986, a drop from 1985. Still, this group of nations is given top priority in Tokyo's aid program; Japan rarely makes a significant ODA decision without considering possible ASEAN reactions.

Southwest Asia - This region has traditionally received the smallest share of Japan's aid to Asia, but its ratio jumped from 15 percent of total bilateral flows in 1985 to almost 22 percent in 1986. Four of Tokyo's top 10 recipients are South Asian countries, and during a recent visit, Mr. Kuranari indicated that Japan would lend India an additional Y68.5 billion ($489.3 billion at Y140=$1.00) -- the largest amount Japan has ever lent to that country.

Latin America - Debt problems here prompted the recycling initiative, but ODA is a different story. Latin America received only 8 percent of total bilateral disbursements in 1986 -- partly because the high per-capita income of several Latin American countries makes them ineligible for aid. It appears likely, however, that Japan will increase its activities in Latin America through increased incentives for private initiatives and expanded government/private-sector cooperation in financing loans.

Africa - Africa receives the second-largest share of Japanese aid, about 11 percent of total bilateral flows. The sub-Saharan region is likely to remain in the second slot, both because of its dire needs and because there is still considerable room for expansion. Tokyo tends to stress this area when discussing its humanitarian aid initiatives. Not only does the basic human needs approach apply but since Japan has fewer cultural, political and economic links to this region than any other area in the world, expanded aid is the most obvious way to display an absence of ulterior economic motives.

Few, if any, of the recycling funds are likely to wind up in Africa, largely because most African debt is owed to governments rather than to banks and conventional assistance may be more effective for the region. Consequently, Japan recently promised an additional $500 million in grant aid for sub-Saharan Africa and other LLDCs. Kyodo News Service reports that Kenya may be the first country to receive this aid; Zambia and the Sudan have also expressed an interest.

Middle East - This is the only region for which Japan has not outlined an assistance strategy during the last year. Like Latin America, many per-capita incomes here are too high for ODA eligibility. With regard to aid considerations, though, Foreign Ministry officials point out that the region's oil supplies do influence Tokyo's policy.

In addition to resource concerns, "comprehensive national security" considerations are also noticeable in the Middle East. First embraced by then-Prime Minister Masayoshi Ohira in 1980, comprehensive national security involves both military and non-military factors. This linking of defense, energy and other economic needs has led to an increase in ODA for those countries (in the Middle East and elsewhere) that are important to the Western alliance. Egypt, for example, is one of Tokyo's top ten aid recipients. Moreover, Tokyo has reportedly also approved a Y54.4 billion ($388.6 million) Ex-Im Bank/World Bank co-financed loan for Turkey under its recycling plan.

Criticisms

Two of the most controversial aspects of Tokyo's aid program concern mixed credits and tied aid. American critics have long charged that Japan and European nations mix foreign aid with export credits on commercial terms to win contracts in developing countries. Tokyo stresses that it shares this country's desire to minimize the use of mixed credits and, as a result, joined other OECD members earlier this year in a move to tighten the rules governing project financing (see JEI Report No. 10B, March 13, 1987, and No. 12B, March 27, 1987).

While the fight over mixed credits has ended -- at least for now, critics continue to charge that the informal procedures involved with Japanese programs limit project participation to Japanese businesses.*** For example, Tokyo employs a "request only" policy, meaning that development proposals cannot originate in these government agencies that are involved in the aid program. While this is based on the premise that the objectives of the recipients should be respected, it also allows Japanese companies to lobby recipient governments to request specific projects. Moreover, the requirements for official feasibility studies before a project is approved encourage the participation of Japanese consultants at an early stage in the process, paving the way for later Japanese contracts.

***On paper, Japan's record looks good. OECD figures show that Japan's use of tied aid is lower than that of the United States.

The request-only procedure has at least one other unfavorable consequence, according to recipient-nation observers. Since developing-country elites are in a position to issue requests, projects are often capital-intensive rather than directly oriented to the needs of the poor. In view of these complaints Tokyo has taken steps to correct the situation by sending study missions to developing countries to determine assistance needs and suggest possible aid projects.

Another obstacle is the fact that ODA decisions often require the consensus of four ministries whose interests and priorities differ: Foreign Affairs, Finance, International Trade and Industry, and the Economic Planning Agency. These bureaucratic stumbling blocks are only intensified by the fact that several other agencies are also involved in specific aspects of ODA programs (see Table 6).

Table 6: Japan's Aid Expenditures by Ministry, FY 1985-FY 1986

(in billions of yen)

Ministry or Office	FY 1985 (Revised)	FY 1986 (Initial)	Percent Change
Office of the Prime Minister			
Grants to Overseas Economic Cooperation Fund	Y29.5	Y31.8	7.8%
Ministry of Foreign Affairs	286.0	305.9	7.0
Economic development assistance	115.0	124.0	7.8
Grants to Japan International Cooperation Agency	83.6	90.9	8.7
Subscription to Japan International Cooperation Agency	4.3	4.9	14.0
Contributions to international aid programs*	81.1	84.1	3.7
Ministry of Finance	232.5	250.0	7.5
Subscription to Overseas Economic Cooperation Fund	169.0	180.0	6.5
Food production projects	59.4	61.0	2.7
Subscription to multilateral development banks	4.1	9.1	123.0
Ministry of Education			
Allowance for government-sponsored students in Japan	6.7	7.9	17.9
Ministry of Health and Welfare			
Contributions to World Health Organization	6.2	5.8	-6.5
Ministry of Agriculture, Forestry and Fisheries			
Promotion of international fisheries cooperation	4.3	4.4	2.3

Ministry of International Trade and Industry	16.1	17.5	8.7
Overseas development planning research	6.6	7.1	7.6
Foreign technician training projects	3.7	4.1	10.8
Dispatch of private experts	4.7	5.2	10.6
Total	581.2	623.2	7.2
*Contributions to international aid programs	81.1	84.1	3.7
United Nations	16.1	15.6	-3.1
U.N. Food and Agriculture Organization	4.2	5.2	23.8
UNESCO	1.7	3.8	123.5
Organization for Economic Cooperation and Development	2.6	3.0	15.4
U.N. Development Program	13.5	14.2	5.2
World Reserve Food Program	2.7	3.1	14.8
U.N. Children's Fund (UNICEF)	3.0	3.3	10.0
U.N. High Commissioner's Refugee Program	11.5	11.0	-4.3
U.N. Population Activity Fund	9.0	9.6	6.7
Middle East Refugee Help Program	2.0	2.0	0.0
International Agricultural Study Conference Group	2.8	3.1	10.7
Other	12.1	10.2	-15.7

Source: Ministry of Finance, Financial Statistics of Japan, Fiscal Year 1986

An Expanded Role For Japan?

Although Japan's recycling initiative and revised doubling plan have been warmly welcomed in developing and industrialized countries, there has already been some grumbling about the program's scope. In short, observers say, Tokyo is in a position to do even more. According to Washington Post columnist Hobart Rowen, for example, the recycling plan is "not enough but at least a start." Moreover, the Economist points out that $10 billion of the $30 billion total was already pledged before the announcement of the package and that the $2 billion special fund for the World Bank amounts to nothing more than encouraging the organization to raise more money in Japan's capital market.

There have been specific proposals outlining a greater role for Japan in international development. A highly publicized one comes from the World Institute for Development Economics Research, headed by former foreign minister Saburo Okita. The organization suggests that Japan recognize that it will run a substantial current account surplus for the next several years and rather than trying to eliminate the surplus, should send more excess funds to the developing countries. WIDER has suggested channeling $25 billion annually to the LDCs over a five-year period and tripling the 1985 ODA figure by 1990 (see JEI Report No. 35B, September 18, 1987).

Another proposal, this one originating with American observers, calls for a Japanese "Marshall Plan" on the order of American efforts in postwar Europe. Japanese spokesmen say that would be difficult since Japan's surplus funds are in the private sector. The government, by contrast, continues to run a sizable budget deficit. For this reason Tokyo has made private-sector participation an integral element of the recycling initiative.

The U.S. Senate, too, has jumped on the proposal bandwagon. In September it added an amendment to S 1174, the Defense Department authorization bill, calling on Japan to increase its ODA disbursements to 3 percent of GNP by 1992 (see JEI Report No. 37B, October 2, 1987). In light of Japan's current 0.29 percent level, this target is unlikely. Finance Minister Kiichi Miyazawa reportedly expressed anger about the amendment, especially in light of Tokyo's present efforts to expand assistance via its $30 billion plan.

Yet another suggestion is that Japan should contribute more to the political leadership of the multilateral institutions, especially the World Bank. According to the Far Eastern Economic Review, for example, "Japan is in the best position to fill much of the vacuum caused by the lack of U.S. intellectual leadership in the World Bank." This may be a viable option, although no moves have been announced as yet. To date Japan has been content to expand its financial contributions and follow Washington's political leadership.

Given Tokyo's preference for aid to promote international stability, it is not unlikely that there will be a continuing search for creative government/private-sector cooperation on debt and development problems. With regard to financial commitments, however, officials intend to wait until they can assess the success of the $30 billion plan before pledging any major new funds.

Conclusion

MITI's 1986 White Paper on Economic Cooperation cites four structural problems in Japan's aid efforts. First, the debt problem constitutes an obvious impediment to development goals. Second, the low level of primary commodity prices reduces the foreign exchange earnings of developing countries and restricts their economic growth. Third, trade protectionism could inhibit economic growth in the LDCs since the expansion of world trade is an "important precondition of economic and social development." And fourth, problems of food and agricultural development in the LDCs impede the attainment of other development goals.

These problems notwithstanding, 1986-87 may represent a landmark for Japan's assistance program. The decision to embrace new aid programs (including those that respond to debt problems) and as take the lead on issues such as MIGA may indicate the beginning of a more expansive role for Japan. At the very least these initiatives provide sound evidence of Tokyo's intention to take the "responsibilities of a surplus nation" seriously.

For further information contact Eileen Marie Doherty.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix: Distribution of Japan's Bilateral ODA Commitments, 1985-86*

(in millions of dollars)

	1985	1986	Percent Change 1985/86	Percent of Total 1985	Percent of Total 1986
Public utilities	$1,756.6	$1,510.8	-14.0%	43.1%	34.8%
Planning and public administration	25.8	30.8	19.4	0.6	0.7
Agriculture and fisheries	699.5	521.9	-25.5	17.2	12.0
Industry, mining and construction	432.1	530.5	22.8	10.6	12.2
Trade, banking, tourism and services	18.7	30.7	64.2	0.5	0.7
Education	317.8	362.6	14.1	7.8	8.4
Health	161.9	135.5	-16.3	4.0	3.1
Social infrastructure and welfare	117.7	158.1	34.3	2.9	3.6
Multisector	98.6	23.7	-76.0	2.4	0.5
Unspecified**	144.6	245.4	69.7	3.6	5.7
Not allocable by sector***	302.4	792.0	161.9	7.4	18.2
Total	4,075.6	4,341.9	6.5	100.0	100.0

*Commitment basis

**Includes administrative costs.

***Includes commodity loans, food aid, debt relief and other types of aid.

NOTE

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Bears Trample Global Stock Markets

The spectre of the Great Depression loomed in the background as global financial markets experienced record-shattering losses and recoveries during the third week of October. As government and monetary officials attempted to calm markets, waves of selling and buying started in New York and swept around the globe. Most analysts had been expecting a correction, arguing that the U.S. stock market was overvalued. When the correction turned into a rout, however, it raised the prospects for recession and focused attention on the huge U.S. fiscal and trade deficits. While these developments highlight the globalization of financial markets, they have also revealed more subtle relationships.

Capping an extended drive, the Tokyo Stock Exchange Nikkei average of 225 stocks hit a record high of 26,646.43 on October 14 (see Table 1). Reacting to a 100-point drop in the Dow Jones industrial average on October 16, the Nikkei index fell 620 points the following Monday, a 2.3 percent decline. In response to the Dow's 508-point plunge later that day, Tokyo stock prices plummeted more than 3,836 points or 14.9 percent on October 20. The decline easily surpassed previous record declines in percentage as well as absolute terms (Table 2). Immediately following "black Tuesday," the Tokyo market rebounded 2,037.32 points, the largest single daily gain on record. This was only the beginning of the rollercoaster ride, however, as markets around the globe experienced wild swings. The Tokyo market dropped 1,203.23 points on Friday, October 19, and 1,096.22 points the following Monday before pulling itself up 632.4 points on Tuesday.

Just as President Reagan tried to calm U.S. markets, Prime Minister Yasuhiro Nakasone, Finance Minister Kiichi Miyazawa, Bank of Japan governor Satoshi Sumita and Liberal Democratic Party president-elect Noboru Takeshita all made statements berating investors for ignoring Japan's sound economic condition. The TSE board tried to dampen speculation on October 20 by raising the minimum margin requirement from 30 percent to 50 percent of the purchase price. The impotence of policymakers in Japan and elsewhere was reflected by the continued volatility of global stock markets, which spilled over into foreign exchange, bond and other markets.

The Osaka Stock Exchange's futures market, which sells a contract based on a basket of 50 Japanese stocks, went into a tailspin. Starting October 12 at Y1,410 ($10.07 at Y140=$1.00), prices fell to Y1,156 ($8.26) on October 26. The Osaka exchange temporarily closed the futures market on October 20 because the TSE plunge that day would have forced the price of futures contracts to move more than the 42 yen daily limit; the next day the Osaka board changed the daily ceiling to 250 yen. The change will help protect investors from extreme swings in the TSE average by allowing them to make larger hedges.

The yen-dollar exchange rate has also been battered. The yen strengthened against the greenback during the week of October 12-16 and hit a high of Y141.35 October 19. Throughout the rest of the week it slipped, however, ending at Y144.15. The following Monday the yen again reversed course and rose to close at Y141.85.

Interest rates, which had been creeping up, were pushed down by the Bank of Japan in an effort to reassure investors. In fact, fears of a hike in the official discount rate may have added to investor concerns and helped precipitate the big Japanese stock sell-off. The Bank of Japan purchased Y200 billion ($1.4 billion) in commercial bills and Y50 billion ($357.1 million) worth of government bonds October 21 to insure adequate liquidity to satisfy the hectic trading in equities. Interest rates on bellwether government bonds fell from 6.442 percent to 5.579 percent between October 19 and October 26.

The impact of all this on the Japanese economy is a hotly debated topic. It is estimated that Y57 trillion ($407.1 billion) was stripped from the market value of Japanese securities on October 20 and that proportional amounts were lost on October 23 and 26. Estimates of the impact on gross national product growth range from reductions of 0.3 percentage point to 1.8 points. On the other hand, government officials hope that the fallout will be limited, if Japanese investors can be convinced to remain in the market and to pursue a long-term investment strategy. Corporate assessments of the damage vary widely. Most, like Sony Corp. and Nippon Telegraph and Telephone Corp., see little if any negative impact on their operations or plans. Others, like Fujitsu, Ltd. and Nissan Motor Co., Ltd., are more concerned.

Table 1: Recent Tokyo Stock Exchange Performance

Date	Nikkei 225 Stock Average	TSE Composite Stock Index	Volume (millions of shares)	Value (billions of yen)
10/12	26,284.65	2,156.17	662.32	Y3,960.6
10/13	26,400.63	2,161.69	1,336.72	3,970.7
10/14	26,646.43	2,181.47	1,401.80	4,007.0
10/15	26,428.22	2,158.61	952.89	3,965.4
10/16	26,366.74	2,152.98	767.85	3,955.3
10/19	25,746.56	2,101.17	619.74	3,860.4
10/20	21,910.08	1,793.90	485.26	3,295.9
10/21	23,947.40	1,962.41	1,116.40	3,605.5
10/22	24,404.35	1,989.49	1,408.55	3,655.2
10/23	23,201.12	1,894.97	1,138.88	3,481.6
10/24	23,298.78	1,906.32	572.73	3,502.4
10/26	22,202.56	1,818.25	665.16	3,340.6
10/27	22,834.96	1,854.27	939.84	3,406.8

Table 2: Record Losses on the TSE Nikkei Average

	Points		Percentage	
Rank	Decline	Date	Decline	Date
1	3,836.48	10/20/87	14.90%	10/20/87
2	1,203.23	10/23/87	10.00	3/5/53
3	1,096.22	10/26/87	8.69	4/30/80
4	831.32	4/27/87	7.68	8/16/81
5	658.28	5/20/87	6.97	12/14/49
6	654.81	7/20/87	6.73	3/30/53
7	647.77	6/22/87	6.61	6/24/72
8	637.33	9/16/86	5.93	8/19/81
9	620.18	10/19/87	5.41	10/9/84
10	550.45	3/30/87	5.03	8/23/81

Source: Nihon Keizai Shimbun

Probably the most interesting aspect to be revealed is that it is expectations and perceptions that link equity markets around the globe, not the actual flow of funds. Despite the relatively small amount foreign investors have put into U.S. securities, worries by American investors that a weaker dollar would drive foreign investors away from U.S. bond and equity markets is said to have been a prime cause of the New York Stock Exchange's decline. Japanese investors were worried about the Dow's drop, but many Japanese investment firms counseled their clients to hold on to their portfolios and even hunt for bargains. Although net purchases of foreign stocks by Japanese investors had been rising earlier this year, activity has leveled off in the past two months.

On the other hand, foreigners are said to have contributed to the subsequent declines of the TSE average, particularly on October 26. Japanese analysts guessed that foreigners were liquidating their Tokyo holdings in order to meet settlement obligations at home. On the upside, Japanese investors are just as happy as Wall Street that the administration and Congress seem to be moving toward a compromise that would significantly reduce the U.S. budget deficit. In any event, it is clearer than ever that barriers between national markets are dissolving and that policy cooperation and coordination is a prerequisite to success.

Jon Choy

Tokyo Seeks End To Land-Price Spiral

One consequence of Japan's recent prosperity has been a rapid increase in land prices and real estate speculation. The climb has gone so high as to put buying a house in any of the large metropolitan areas out of the reach of the middle class. In fact, the run-up of the Tokyo Stock Exchange that preceded the October 20 crash was linked to rising real estate prices -- increasing stock values meant more collateral for housing loans and an increase in housing demand in certain markets. On the other hand, a hike in housing demand produces rising real estate values and money can be put into the stock market.

Government and Liberal Democratic Party officials want to break this vicious spiral with the following tools:

- The Home Affairs Ministry has proposed raising taxes on undeveloped plots as small as 100 square meters (1,075 square feet) in the Tokyo, Osaka and Nagoya metropolitan areas. At present a special tax of 1.4 percent to 3 percent applies to lots of 300 square meters (3,226 square feet) or more in Tokyo and to lots of 500 square meters (5,376 square feet) and up in other cities. The Home Affairs Ministry would like to raise the levy effective April 1, 1988, but has not proposed an exact figure. The new tax would be in effect for at least two years and longer if necessary.

- Taxes on farm land are still an extremely sensitive issue. However, a consensus does seem to be emerging in favor of change. As it now stands, a farmer can avoid heavy assessments by agreeing to farm a plot for several years. His heirs may continue to pay low taxes and avoid inheritance taxes if they too agree to farm the land. Repeal of this tax break would deal a severe blow to owners of farm land in metropolitan areas and is bound to bring up old issues of food security. Nevertheless, the government seems willing to confront the issue at long last.

- Levying capital gains taxes on real estate transactions is another target for reform. Currently, a seller may avoid stiff levies if the money is immediately invested in other real estate, with obvious consequences for prices. Changing this popular regulation may prove politically costly, however.

- The Finance Ministry has come down hard on banks and other financial institutions that lend money for real estate speculation. An October 19 notice encourages lenders to investigate loan requests more thoroughly. The purpose of the loan, the true state of the supporting collateral (improved or not), and lot on trade." Since a trade/reconciliation package appears unrealistic, budgetary concerns will come first for now and the trade bill will be of secondary importance.

From Wall Street's perspective this is just fine. Many observers fear that the shaky stock market will not respond well to congressional approval of what is viewed as protectionist legislation. If Congress wants to approve a bill this year, it will have to tread carefully, keeping in mind the fact that many investors are worried that the bill might spark foreign retaliation. Indeed, since there has been so much protectionist rhetoric on Capitol Hill -- and since this country's trading partners believe that nearly all the provisions of the bill run counter to their own interests -- some foreign investors have warned that passage of even a toned-down trade package could send chills through the stock and bond markets.

In the view of such observers, the wisest course may be to take no action at all. Legislators have not publicly espoused this view; on the contrary, the leadership still says that the trade bill will be on the president's desk by the end of the year. It is not clear whether this position is held by the majority of conferees -- or indeed by the leadership in private. It is true, however, that only non-controversial proposals have been discussed thus far; this is probably both because there is no consensus on controversial proposals and because no one wants to increase the uncertainty about the economy.

Consequently, there has been some talk about wrapping up work on HR 3 early next year. If the bill is sent to the president in January or early February, say observers, there is a good chance that 1988 election concerns will not affect its fate. If, on the other hand, the delay stretches into March or April, the probability of politicization increases enormously. For the present, however, Congress appears to be doing what countless economists have advocated: attacking the trade deficit by cutting the budget deficit.

Eileen M. Doherty

Notes

Supercomputers - Tokyo's new procedures for purchases of supercomputers by government agencies, research institutions and national universities (see JEI Report No. 29B, July 31, 1987) have produced sales breakthroughs for the top two U.S. supercomputer manufacturers. On October 15 Control Data Corp. revealed that it had won a contract from the Tokyo Institute of Technology -- its first supercomputer sale ever to a Japanese customer public or private. The institute, part of the national university system, ordered the new ETA-10 system made by CDC's ETA Systems Inc. supercomputer subsidiary. The $20 million unit will be installed next March.

Cray Research Inc. has also announced a first -- a supercomputer contract from Japan's public sector. The world industry leader disclosed October 26 that the Ministry of International Trade and Industry had ordered a $15 million X-MP/216 system for installation at an Agency for Industrial Science and Technology facility during the first quarter of 1988. Cray has installed eight supercomputers in Japan since mid-1983, all for private organizations. The closest it had come to a government sale before the MITI order was a contract from Nippon Telegraph and Telephone Corp. when it was still a public corporation.

Money for the two supercomputers will come out of the Y145 billion ($1 billion-plus at Y140=$1.00) earmarked in the FY 1987 supplementary budget for public-sector purchases of big-ticket foreign products. About one-fifth of these funds, which are part of the Y6 trillion ($42.9 billion) economic stimulus package unveiled this past May (see JEI Report No. 21B, June 5, 1987), have already been committed. Still pending is the single-largest contract -- Y38.9 billion ($277.9 million) for jetliners for government use (see Table). Trade sources say Tokyo has tentatively selected Boeing Co.'s new 747-400 over the McDonnell Douglas Corp. MD-11 and Airbus Industrie S.A.'s A340. A firm order for two of the Boeing planes, which are scheduled for rollout in January 1988, is expected by yearend, with delivery set for 1991.

FY 1987 Supplementary Budget For Government's Import Purchases

(in billions of yen)

Administrative Unit	Value	Principal Items
National Diet	Y1.1	Foreign books and materials
Courts	0.1	Foreign books
Prime Minister's Office	38.9	Aircraft for government use
National Police Agency	5.9	Helicopters and guard command vehicles
Science and Technology Agency	9.2	Testing and research equipment and test plane
Environment Agency	1.0	Pollution measuring and analysis equipment
Ministry of Justice	0.1	Foreign books
Ministry of Foreign Affairs	5.3	Communications-related equipment
Ministry of Finance	3.1	Narcotics detection equipment
Ministry of Education	26.7	Supercomputer and other research equipment
Ministry of Health and Welfare	8.8	Medical research equipment
Ministry of Agriculture, Forestry and Fisheries	4.9	Gene analysis equipment
Ministry of International Trade and Industry	13.1	Supercomputer and testing, analysis research equipment
Ministry of Transport	15.3	Long-distance search and rescue plane
Ministry of Posts and Telecommunications	6.0	Space optical communications ground center and radio interferometer
Ministry of Labor	1.7	Medical precision equipment
Ministry of Construction	3.7	Helicopter for use in natural disasters
Ministry of Home Affairs	0.2	Helicopter for fire fighting
Total Imports	145.0	